

PUBLIC UTILITIES COMMISSION

505 VAN NESS AVENUE
SAN FRANCISCO, CA 94102-3298

**August 29, 2003****Agenda ID# 2376**

Alternate Agenda ID#2378

Agenda ID # 2636

Alternate Agenda ID# 2637

Ratesetting

TO: PARTIES OF RECORD IN RULEMAKING 01-09-001 and
INVESTIGATION 01-09-002

RE: NOTICE OF AVAILABILITY OF DRAFT DECISIONS AND ALTERNATE
DRAFT DECISIONS REGARDING PHASE 2A AND 2B AUDIT ISSUES

The following draft decisions and alternate draft decisions, which were issued on the above date, are available to the parties and the public:

- Administrative Law Judge (ALJ) Kenney's draft decision regarding Phase 2A audit issues. ALJ Kenney was previously designated as the principal hearing officer for Phase 2A of this proceeding.
- Commissioner Kennedy's alternate draft decision to ALJ Kenney's draft decision.
- ALJ Thomas's draft decision regarding Phase 2B audit issues. ALJ Thomas was previously designated as the principal hearing officer for Phase 2B of this proceeding.
- Commissioner Kennedy's alternate draft decision to ALJ Thomas's draft decision.

An Internet link to each of the previously identified documents was sent via e-mail to all the parties on the service list who provided an e-mail address to the Commission. An electronic copy of these documents can be viewed and downloaded at the Commission's web site (www.cpuc.ca.gov). A hard copy of these documents can be obtained by contacting the Commission's Central Files Office [(415) 703-2045].

The previously identified draft decisions and alternate draft decisions were issued in a ratesetting proceeding that is subject to Pub. Util. Code § 1701.3(c). Pursuant to Resolution ALJ-180, a Ratesetting Deliberative Meeting to consider

these drafts may be held upon the request of any Commissioner. If that occurs, the Commission will prepare and mail an agenda for the Ratesetting Deliberative Meeting 10 days before hand, and will advise the parties of this fact and of the related ex parte communications prohibition period.

The Commission may act on the previously identified draft decisions and alternate draft decisions at its first regular meeting occurring no earlier than 30 days after the date the drafts are issued. The Commission may also postpone action until later. If the Commission acts, it may adopt all or part of a draft as written, amend or modify it, or set it aside and prepare its own decision. Only when the Commission acts does the decision become binding on the parties.

Parties may file separate comments on each draft decision and alternate draft decision as provided in Article 19 of the Commission's "Rules of Practice and Procedure." These rules are accessible on the Commission's website (<http://www.cpuc.ca.gov>). Pursuant to Rule 77.3 opening comments on each draft shall not exceed 25 pages. Comments must be served separately on the ALJ and the assigned Commissioner, and for that purpose I suggest hand delivery, overnight mail, or other expeditious method of service. In addition to service by mail, parties should send their comments in electronic form to ALJ Kenney at tim@cpuc.ca.gov, ALJ Thomas at srt@cpuc.ca.gov, Timothy Sullivan at tjs@cpuc.ca.gov, and to those listed in the appearance and state service portions of the service list who provided an electronic mail address to the Commission.

/s/ ANGELA K. MINKIN by PSW

Angela K. Minkin, Chief
Administrative Law Judge

ANG:hkr

Decision **ALTERNATE PROPOSED DECISION OF COMMISSIONER KENNEDY**
(Mailed 8/29/03)

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Order Instituting Rulemaking on the
Commission's Own Motion to Assess and Revise
the New Regulatory Framework for Pacific Bell
and Verizon California Incorporated.

Rulemaking 01-09-001
(Filed September 6, 2001)

Order Instituting Investigation on the
Commission's Own Motion to Assess and Revise
the New Regulatory Framework for Pacific Bell
and Verizon California Incorporated.

Investigation 01-09-002
(Filed September 6, 2001)

INTERIM OPINION REGARDING PHASE 2B AUDIT ISSUES

TABLE OF CONTENTS

Title	Page
INTERIM OPINION REGARDING PHASE 2B ISSUES	2
I. Summary	2
II. Background on Phase 2A	5
A. Audit Scope	5
B. Involvement of Commission’s Telecommunications Division(TD) and Office of Ratepayer Advocates (ORA)	6
C. Findings of Overland Audit	6
D. Phase 2A vs. Phase 2B.....	7
III. General Issues	7
A. Pacific’s Books and Generally Accepted Accounting Principles	7
B. Accurate Accounting Essential to Avoid Ratepayer Harms.....	11
C. Materiality	13
D. Overland’s Qualifications and Conduct in the Audit.....	15
1. Certified Public Accountant (CPA) Requirement	15
2. Generally Accepted Auditing Standards.....	17
3. NARUC Requirements	17
4. Policy Discussions	18
5. Pacific’s Allegation Concerning Errors by Overland.....	20
IV. Undisputed Audit Adjustments	20
V. Disputed Audit Adjustments	21
A. Revenue and Other Operating Income	22
1. Contingent Liabilities	22
2. Uncollectible Revenues and Settlements	26
3. Directory Publishing.....	30
B. Operating Expenses	30
1. Local Number Portability Costs.....	30
a) Introduction	30
b) Criteria for Deferral as a Regulatory Asset – FAS 71.....	33
c) Jurisdictional Separations.....	36
d) Conclusion.....	37
2. Local Competition Implementation Costs.....	37
3. Merger Savings	40
4. Software Buy-Out Agreement.....	42
5. Incentive Pay Accruals	44

Title	Page
6. Other Expense Related Issues – “Royalty Payment”	44
C. Employee Benefits	45
1. Other Post Retirement Costs (FAS 112)	45
2. Other Employee Benefits Issues.....	46
D. Depreciation Accounting for Intrabuilding Network Cable Amortization	46
E. Income Taxes.....	48
1. Accumulated Deferred Income Taxes.....	48
2. Sales and Use Tax Accruals	49
3. Payroll Tax Correction.....	50
4. Booking of Deferred Taxes.....	51
5. Ameritech Severance Accruals.....	53
F. Net Plant Accounting	54
1. Property Records	54
2. FCC Continuing Property Records (CPR) Audit.....	54
3. Pacific’s 1999 Computer Inventory.....	55
4. SAVR Retirements.....	56
5. Other Net Plant Issues	58
a) Restructuring Reserve Adjustment.....	58
b) Depreciation Adjustment.....	59
c) Allowance for Funds Used During Construction (AFUDC).....	60
d) PBOP Pre-Funding Plant Adjustment.....	61
G. Other Rate Base Items.....	62
1. Cash Working Capital	62
2. Other Rate Base Calculation Issues	67
a) Prepaid Directory Expense.....	68
b) Prepaid Pension Assets.....	69
c) Accrued FAS 112 Liability	69
d) Accrued Vacation Pay Liability	71
e) Accrued FAS 106 Liability	71
f) Accrued Contingent Liabilities	72

Title	Page
H. Affiliate Transactions.....	73
1. Introduction	73
2. Undisputed Affiliate Transactions Adjustments.....	73
3. Disputed Affiliate Transactions Adjustments.....	74
a) Internal Accounting Controls.....	75
b) Compliance With Time Reporting Document Retention Requirements.....	78
(1) 1998 Affiliate Oversight Group (AOG) Compliance Review of SBC Operations.....	79
(2) SBC Operations “Image Maker” Program	79
(3) Centralized Tracking for Legal Matters.....	80
c) Affiliate Issues: Management Fees and Research Assessment.....	82
(1) Alleged Excessive Management Fees.....	82
(2) Corporate Charges for Research	83
d) Compliance With Affiliate Transaction Requirements.....	84
(1) Overview	84
(2) Booking of Parent Costs	85
(3) Booking of Costs for Shared Services Affiliates.....	86
(4) Services Provided by Pacific Bell to Affiliates	86
e) Other Compliance Issues Concerning Affiliate Transaction Rules - AMDOCS	88
f) Transfer or Use of Customer Information, Trademarks and Other Intangible Assets	89
g) Transfer of Pacific Bell Directory to Pacific Telesis Group	90
h) Advanced Services, Inc.	92
(1) Appropriateness of Considering ASI in this Proceeding.....	93
(2) Ratepayer Funding of DSL Development Costs.....	93
i) Affiliate Transactions Audit Adjustments.....	97
(1) Operating Revenue Adjustments – 1999 Employee Transfer Fee.....	97
(2) Operating Expense Adjustments for Executive Compensation.....	97
(3) Operating Expense Adjustment for Executive Award Payments Allocated to Pacific	99
(4) Executive Compensation Allocated From Parent to Pacific Bell Directory.....	100

Title	Page
(5) Special Executive Compensation Allocated From Parent to Pacific Bell Directory	100
(6) Executive Compensation Allocated from SBC Operations	101
(7) Executive Compensation Allocated from SBC Services	101
j) Legal Expenses.....	102
(1) Legal Expenses Allocated from Parent to Pacific	102
(2) Legal Expenses Allocated From Parent to Pacific Bell Directory	103
k) Public Relations and Corporate Sponsorship Allocated from Parent to Pacific and Pacific Bell Directory.....	103
l) Corporate Development Costs	105
m) Strategic Planning Costs.....	106
n) Parent Out of Period Expense	106
o) Regulated and Nonregulated Cost Allocations	107
(1) Marketing Service – Affiliate Billings.....	107
(2) Allocation of National-Local Strategy Implementation Costs.....	108
(3) 1997 Corporate Sponsorship Costs – Pacific Bell Park	109
(4) Depreciation Expense Allocation.....	110
(5) Product Advertising Expense.....	111
(6) External Relations Costs Assigned to Regulated Operations	111
(7) Allocation of Customer Service Expenses	114
(8) InterLATA Service Application Costs.....	115
(9) Fluctuation Analysis	115
(10) C-CAM Updates	117
(11) Subsidiary Account Translation Data.....	117
(12) Enhanced Sales Time Reporting Systems (ESTRS)	119
VI. Audit Discovery Disputes.....	119

Title	Page
VII. Phase 2B Remedies (Audit – Pacific Bell)	124
A. ORA’s Proposed Remedies - Summary	124
B. Correction of IEMR Reports for 1997-99	127
1. Correction of IEMR Reports for 2000-2001	127
2. Sharing in 1997 and 1998	128
C. Interest on 1997-98 Shareable Earnings	129
D. Method of Payment.....	131
E. Suspension of Sharing in 1999.....	133
F. Proposed 18 Percent Interest on All Underreported Earnings.....	136
G. ORA Proposal to Reinstate Sharing.....	138
H. No Additional Auditing of 1997-99 Transactions Needed	138
I. Audit of Pacific’s 2000-02 Reporting Should Commence When Ordered	139
J. \$20 Million “Incentive” Payment.....	140
K. Penalty Phase	141
L. Revisions to NRF Monitoring Program	142
VIII. Recovery of Audit Costs.....	142
Comments on the Alternate Proposed Decision	147
Findings of Fact	147
Conclusions of Law	165
ORDER.....	179
APPENDIX A	
APPENDIX B	
APPENDIX C	
APPENDIX D	

INTERIM OPINION REGARDING PHASE 2B ISSUES**I. Summary**

This decision acts on portions of an audit of Pacific Bell Telephone Company (Pacific)¹ that the Commission conducted as part of its oversight of the “New Regulatory Framework” (NRF). We find that a number of audit findings are justified and that in some instances Pacific over-reported expenses. In other situations, we find that Overland misinterprets Commission policies concerning the accounting treatment of Pacific’s expenses. Although we find evidence of accounting errors and misinterpretations of Commission policy, we do not find any evidence of fraudulent action by Pacific. Indeed, as the reader of this decision will soon note, the issues are arcane, complex, and confusing.

The NRF framework, implemented in 1990,² relaxed regulation of certain large telephone companies in California in exchange for assurances regarding service quality, protection of ratepayer funds, and other measures. This phase of the proceeding (Phase 2B) examined all but the four largest issues presented in that audit; Phase 2A examined those four issues and will be the subject of a separate decision issued simultaneously.

Phase 2B examined 68 accounting issues identified by Overland for scrutiny in this proceeding. As a result of Overland’s review of these 68 issues,

¹ Pacific has since changed its name to SBC. Because we discuss activities of SBC, Pacific’s parent company, in this decision, we use the name Pacific to identify the regulated telephone company for the sake of clarity.

² Decision (D.) 89-10-031, 1989 Cal. PUC LEXIS 576, 33 CPUC 2d 43 (1989), 107 PUR 4th 1 (1989).

Overland proposed adjustments in Pacific's revenues of \$625.3 million and adjustments in Pacific's ratebase of \$2134.7 million. Of these proposed adjustments, 17 totaling \$118.4 million in revenue adjustments were uncontested. Of the 51 contested issues, we sustain Overland's analysis on 34 and reverse its recommendation on 17. We reach these conclusions based on the evidence submitted at hearing and our analysis of Commission policies. Concerning these contested issues, we order Pacific to make 29 adjustments in revenue, and 10 adjustments to its ratebase.

As a result of our decision today, we order Pacific to increase its revenues booked to our regulatory accounts by 177.0 million in 1997; by \$207.5 million in 1998; and by \$21.5 million in 1999. Thus, Pacific's revenue requirement adjustments total \$405.9 million for the three years under review. In addition, we order ratebase adjustments (decreases) of \$505.5 million in 1997, \$458.1 million in 1998, and \$411.3 million in 1999. Thus, for these three years ratebase adjustments total \$1374.8 million.

In 1997 and 1998, Pacific was under an obligation to share earnings above a certain threshold with ratepayers. Despite our adjustments here and in the Phase 2A of this proceeding, the adjusted earnings did not rise to a level that requires Pacific to share earnings with ratepayers in 1997 or 1998. The calculations that lead to the determination that no sharing takes place are contained in the Phase 2A decision, but we report its result here as well.

In our companion Phase 2A decision, we found that in 1999 Pacific misused funds earmarked for specific PBOP accounts and, consistent with prior Commission decisions, we ordered a refund to customers of \$162 million (including interest). We ordered this refund even though under the NRF rules in effect in 1999, Pacific was under no obligation to share earnings with ratepayers.

We deem the \$162 million to be a refund arising from the misuse of funds and it does not constitute a sharing of earnings.

Certain parties participating in this proceeding have asked that we reverse our decision to suspend sharing in 1999 on the ground that Pacific misled us into making it. We do not find sufficient evidence to support this allegation.

Therefore, while we require Pacific to remedy its earnings reporting for 1999, the changes we order do not require ratepayer sharing in that year.

The audit adjustments that we adopt in this decision are reflected in Appendices A, D and E to our Phase 2A decision.³ In addition, we require Pacific to prepare schedules that identify each of this decision's adopted adjustments and demonstrate that it has properly reflected the ordered adjustments in its financial reporting. Pacific shall file the schedules, along with supporting documentation, as a compliance Advice Letter filing due no later than 90 days after the effective date of this decision.

³ The parties also presented joint schedules of 1) the audit adjustments (disputed and undisputed) and 2) the issues in dispute in this proceeding, showing the parties' various positions on the issues resolved in this decision. These schedules appear as Appendix B ("Joint Exhibit of Overland Consulting, Inc., ORA, TURN and Pacific Bell Showing Impact of Audit Corrections on Pacific Bell's Reported IEMR Results for 1997-1999") and Appendix C hereto. As to Appendix B, the amounts reported there may disagree with Appendices D and E to the Phase 2A decision, and Appendix A to this decision, to reflect the impact of taxation. Each Appendix is cross-referenced by issue number so parties can track issues across appendices.

II. Background on Phase 2A

A. Audit Scope

When the Commission instituted NRF, it prescribed periodic audits of Pacific. The audits would serve to verify, among other things, that Pacific's financial reporting was accurate, that it was not subsidizing its non-regulated businesses with funds from the regulated local telephone company, and that to the extent ratepayers were to share in Pacific's earnings, Pacific was reporting those earnings correctly. The Order Instituting Rulemaking (OIR) commencing this proceeding identified the follow issues for the Pacific Bell audit:

The scope of the audit is as follows: (1) analyze Pacific's NRF monitoring reports; (2) analyze Pacific's cost allocations and accounting practices and procedures that were established to protect against cross subsidization and anti-competitive behavior; (3) determine whether Pacific and its affiliates are following the Commission's rules for affiliate transactions; (4) determine whether Pacific is properly tracking and allocating costs related to non-regulated activities; and (5) determine whether non-structural safeguards adequately protect ratepayer and competitor interests with respect to non-regulated activities. (D.96-05-036, 66 CPUC 2d 274, 278, and OPs 3 and 4; and Executive Director letter dated September 18, 1998).⁴

⁴ Rulemaking (R.) 01-09-001/Investigaton (I.) 01-09-002, Appendix A.

B. Involvement of Commission's Telecommunications Division(TD) and Office of Ratepayer Advocates (ORA)

ALJ Timothy Kenney,⁵ who handled Phases 1 and 2A of this proceeding, explained TD's role in a discovery ruling:

TD is not a party to this proceeding, but a division of the Commission that advises decision makers. TD's task in this proceeding has been to manage an audit that was ordered by the Commission. The auditors are not expert witnesses hired by a party to this proceeding, but consultants retained by the Commission to perform work that -- given more time and resources -- TD could have performed itself.⁶

During the audit, ORA also sought and was granted permission to conduct its own discovery examining Pacific's actions on issues covered by the audit. Ultimately, Overland presented its audit at hearing, TD managed Overland's contract and facilitated interaction between auditors and Pacific, and ORA actively pursued various issues raised in the audit.

C. Findings of Overland Audit

Overland prepared an audit report that was admitted into evidence during Phase 2A of this proceeding.⁷ In the report, Overland stated that it:

identified 67 corrections [increased by the Supplemental Audit Report⁸ to 72⁹] to Pacific Bell's regulated operating

⁵ ALJ Sarah R. Thomas conducted the Phase 2B hearings in this proceeding and drafted this decision.

⁶ *Administrative Law Judge's Ruling Regarding Pacific Bell's Motion to Confirm its Right to Conduct Depositions*, dated May 14, 2002, at 5-6.

⁷ Exhibit (Exh.) 2A:404.

⁸ Exh. 2B:415 (Supplemental Audit Report).

⁹ *See* Exh. 2B:409 at 5:9-13 (Welchlin Opening Testimony).

revenues, expenses and rate base. Audit corrections to bring financial results into compliance with CPUC requirements increased the regulated intrastate net operating income that Pacific Bell reported during the audit period by \$1.94 billion. This translates into recommended customer refunds under NRF earnings sharing rules of \$349 million for the years 1997 and 1998. NRF earnings sharing rules were suspended by the CPUC effective in 1999. Customer refunds would have totaled \$457 million if the sharing rules had been effective.¹⁰

D. Phase 2A vs. Phase 2B

We address approximately two-thirds of the audit dollar results – attributable to four issues – in the Phase 2A decision. Therefore, whether the decisions we reach here on the remaining one-third will rise to a level requiring Pacific to share earnings with ratepayers depends on the results of Phase 2A. Because we expect the two decisions to issue at about the same time, this decision addresses each Phase 2B audit claim, but does not reach the ultimate issue of whether sharing is required or the amount of such sharing. The Phase 2A decision performs the calculations for both phases and it was in that decision that we determined that sharing would not occur for either 1997 or 1998.

III. General Issues

A. Pacific's Books and Generally Accepted Accounting Principles

Pacific contends that even if we agree with the audit on an adjustment – or Pacific concedes that the auditors' findings are correct – it does not automatically

¹⁰ We explained earnings sharing, and the NRF structure, in our OIR, and incorporate that explanation here.

follow that Pacific's California books¹¹ should be restated in the year in which the error occurred. Rather, Pacific claims that, in certain cases, Generally Accepted Accounting Principles (GAAP) allow adjustment only in the year in which the error was discovered. Because the audit did not take place until 2001, following Pacific's reasoning, the adjustments would occur after the audit period (and after the Commission suspended earnings sharing) and not result in ratepayer sharing.

We disagree that this is the proper means of reflecting the audit changes. In particular, although we look to GAAP for guidance on any specific accounting issue, the entire premise behind the "sharing" of earnings is that we have an accurate picture of Pacific's revenues and costs in the year under review.

Pacific explains that its so-called "FR" books (its witness could not explain the origin of this acronym) are the starting point to create the Intrastate Earnings Monitoring Reports (IEMRs). The IEMRs are the reports directly at issue in this proceeding, as they contain Pacific's California results in the format ordered by the Commission. Historically, the FR books were Pacific's externally reported results, used for Securities and Exchange Commission (SEC) purposes, and thus were governed by GAAP. Even though Pacific started using another set of books – the "ER" books (again, the witness could not explain the acronym) – for external reporting purposes in 1995, it continued thereafter to maintain the FR books in order to produce the IEMR. At that time, Pacific simply "froze . . . the

¹¹ Pacific's California earnings report is entitled the Intrastate Earnings Monitoring Report (IEMR).

accounting requirements for the FR books, and . . . continue[d] to maintain the FR books on exactly the same basis that they were prior to that set of new external [books] being developed.”¹² Any GAAP changes instituted after 1995 are not reflected in the FR books. The only purpose of the FR books after 1995 was to create the IEMR.¹³

¹² 15 RT 1637:10-14 (Wells). We refer to the hearing transcript in Phase 2B by its volume, page and line numbers. Thus, 15 RT 1637:10-14 refers to Volume 15 of the transcript, at page 1637, lines 10-14.

¹³ *Id.* at 1638:26-28.

Pacific concedes that “[t]he Commission has the power to order Pacific to keep its regulatory books in any manner, limited only by the law.” Nonetheless, it claims that anything that results in an adjustment to the FR must follow GAAP: “Because the FR books are kept pursuant to GAAP, where errors have occurred, the corrections to those errors must conform to GAAP.”

Still, Pacific concedes that even under its reasoning, “material” errors might be recorded in the year they occurred: “the adjustments Pacific does not challenge would appropriately be included in the FR books, and should be reported in calendar year 2002 *because they have no material effect* on the previously reported FR financial results for years 1997, 1998, and 1999.”¹⁴ And Pacific also admits that “where an error occurred outside of the FR books, but in the IEMR calculation process, [Accounting Practices Board Opinion] 20¹⁵ [setting forth the requirement under GAAP that a change in an estimate should not be accounted for by restating amounts reported in financial statements of prior periods] does not apply.”¹⁶ Finally, Pacific concedes that the FR books do not even accommodate GAAP changes made after 1995, so it is unclear why changes to the books for 1997-99 would “violate GAAP.”

¹⁴ Pacific Opening/Audit at 25 (emphasis added). We refer to briefs the parties filed in this proceeding by the abbreviated name of the filing party, the round of briefing, and the issue briefed. Thus, for example, Pacific Opening/Audit at 20-21 refers to Pacific Bell’s opening brief on audit issues at pages 20-21, and TURN Reply/Audit at 1-2 refers to TURN’s reply brief on audit issues at pages 1-2.

¹⁵ Exh. 2B:375.

¹⁶ Pacific Opening/Audit at 26.

While GAAP provides useful guidance and consistency with it is appropriate in some circumstances, Pacific is directed to make the changes ordered herein to its books for the year in which the discrepancy occurred and reflect the changes in the IEMRs for the applicable years. We direct these changes because the earnings picture is extremely sensitive to the timing of the booking of expenses and we believe that the NRF compact with ratepayers requires sharing based on the company's performance in a given year, not on its accounting practices. We note that the FR books are in essence the "regulated books" or "scorecard of regulated earnings" that the Commission requires Pacific to keep since they have served no other purpose since 1995. With the restated IEMRs, Pacific shall provide schedules that identify each of this decision's adopted adjustments and demonstrate that it has properly reflected the ordered adjustments in its financial reporting.

B. Accurate Accounting Essential to Avoid Ratepayer Harms

Pacific claims that even if we find that Overland is correct on many of the disputed audit issues, ratepayers were nonetheless unharmed because NRF severs the link between costs and rates.

As ORA points out,¹⁷ there are many ways to judge harm. We rely on Pacific to maintain accurate expense, revenue and rate of return data and submit correct IEMR information so that we can make many important determinations:

- To ascertain whether cost recovery treatment is appropriate and, if so, the amount by which rates should change.
- To decide when individual service rate increases are justified.

¹⁷ ORA Opening/Audit at 7.

- To resolve whether recategorization requests (to move services among the three NRF service categories)¹⁸ should be approved.
- For purposes of universal service proceedings.
- For regulating rates for Category I, such as unbundled network elements.¹⁹
- To monitor the financial impact of regulation.

Pacific, on the other hand, claims that accounting costs – that is, the costs reflected in the IEMR – have no effect on the price of a service under the NRF rules. Therefore, any incorrect accounting accruals did not harm ratepayers, Pacific claims, because its end-user rates did not change as a result of what it reported in the IEMR.

It is true that NRF alters the direct link between a utility's costs and its prices. Under traditional cost-of-service regulation, the Commission calculated Pacific's cost of service, including its cost of capital, and based on that cost

¹⁸ Under NRF, services were classified into three categories. Basic monopoly services were classified as Category I services. Discretionary or partially competitive services were classified as Category II services. Fully competitive services were classified as Category III services. The price for each Category I service was fixed except for an annual adjustment equal to the price-cap index. The price for each Category II service could vary within a price ceiling and price floor. The price floor was increased annually by inflation, and the price ceiling was revised annually by the price-cap index. Prices for Category III services were provided the maximum flexibility allowed by law.

¹⁹ Through purchase of these unbundled network elements (UNEs), Pacific's competitors are able to use portions of its network to offer their own local telephone service. Pacific's expert, Dr. Robert G. Harris, claims that the audit pertains to accounting costs and common costs, which do not affect prices. *See* Exh. 2B:350 at 24 (Harris Direct Testimony). However, common costs do impact price-setting, because UNE prices include a mark-up for shared and common costs, and UNE prices in turn affect the prices competitors charge end users. ORA Reply/Audit at 10.

determined how much revenue Pacific needed to recover those costs. Costs therefore directly impacted how much revenue Pacific could recover.

However, TURN is correct that under NRF, “[d]uring a period when revenue sharing is in effect, a reduction in the amount of net revenues shared with ratepayers constitutes a form of economic harm to those ratepayers.”²⁰ The higher Pacific’s costs as reported in the IEMR, the lower its revenues and ultimately its potentially shareable earnings.

It is also essential to the regulatory process to have accurate information regarding the earnings of companies we regulate. Although NRF is a scheme in which rates do not necessarily change in response to changes in costs or earnings, accurate earnings reports are a critical tool in our ability to monitor the economic impact of our regulations on NRF carriers.

C. Materiality

Pacific invokes a “materiality” threshold and claims that if a single audit correction is not “material,” the Commission should not act upon it. The only reference to materiality that we have been able to find appears in the original decision ordering the audit:

The auditor should adhere to generally accepted auditing standards *with the exception that the materiality threshold should be reduced to a scope determined by DRA*; the Commission is interested in full compliance with its rules and regulations.²¹

²⁰ TURN Opening/Audit at 3.

²¹ D.96-05-036, 1996 Cal. PUC LEXIS 657, at *10-11 (emphasis added). DRA is ORA’s predecessor, and this decision predated the Commission’s decision to reassign the audit to TD.

The Commission made clear that it was imposing a low threshold of materiality in order to insure “full compliance with its rules and regulations.” Thus, to the extent ORA found an item to be material, Pacific’s concession allowing “material” restatements to prior years’ financial results²² undermines its argument. Moreover, as TURN points out, even if a single item of adjustment is immaterial, “materiality needs to be considered in context. If the Commission were only considering the impact of a single [small dollar] issue . . . it may not be material. But where, as here, the Commission’s review is likely to result in a cumulative adjustment in an amount that meets anyone’s definition of material, then every issue should be considered, no matter how small in isolation.”²³ We agree.

We find that, in combination, the audit corrections Overland identified were sufficiently “material” to require the changes in Pacific’s reporting that we order in this decision. A correction is “material” not only because of its impact on shareable earnings. First, as noted above, we use the IEMR and the data upon which it is based for many reasons, rather than only to determine whether ratepayers will share in Pacific’s earnings. Second, even if the issue does not affect the IEMR at a “material” financial level under Pacific’s definition, there may be reasons related to Commission authority and conformity with applicable law and regulation that would lead us to conclude a discrepancy occurred. It is

²² Pacific Opening/Audit at 25.

²³ TURN Opening/Audit at 43.

too limiting to claim that our rules are designed solely to prevent financial harm to ratepayers. Third, an error with a current small dollar impact during the audit period could cause a large financial impact in subsequent years if not corrected.

Therefore, we reject Pacific's claim that we cannot act on an audit recommendation unless it "materially" affects shareable earnings.

D. Overland's Qualifications and Conduct in the Audit

1. Certified Public Accountant (CPA) Requirement

Pacific contended during Phase 2A and 2B of this proceeding that Overland was not qualified to perform the audit because the firm is not registered by the state board of accountancy in California or in any other state and thus is not a certified public accounting firm. We address the contentions in both phases here.

We find no merit in Pacific's allegation that Overland did not meet the criteria established by D.96-05-036. In D.00-02-047, the Commission had before it Overland's proposal to perform the audit,²⁴ which included full disclosure of Overland's qualifications to conduct the audit.²⁵ Indeed, the Commission explicitly recognized in D.00-02-047 that Overland is not a CPA firm, but a consulting firm that employs and subcontracts with CPAs.²⁶ With this

²⁴ D.00-02-047, *mimeo.*, at 7-8 and finding of fact 6; 2000 Cal. PUC LEXIS 184.

²⁵ Exh. 2A:407, Sections V and VI (Overland Consulting's Proposal to Perform a Regulatory Audit).

²⁶ D.00-02-047, *mimeo.*, at 3 and 7.

knowledge in mind, the Commission explicitly authorized TD to hire Overland.²⁷ Thus, the Commission itself determined that Overland met the criteria established by D.96-05-036.

Mr. Harpster, one of the lead auditors, is a CPA with 22 years of regulatory and consulting experience. He has participated in more than 35 proceedings before the Federal Energy Regulatory Commission, courts in Arizona and Louisiana, and numerous state commissions, including four separate proceedings before this Commission involving SoCalGas and PG&E.²⁸

With respect to California utilities, Overland has also performed several significant regulatory audits on behalf of the Commission during the past eight years. In 1994, Overland conducted an audit of the operating expenses associated with Pacific Gas and Electric's (PG&E's) pipeline expansion project. In 1996, Overland performed a regulatory audit of Southern California Gas (SoCalGas) in connection with the company's performance-based ratemaking case. In 1997 and 1998, Overland performed a regulatory audit of PG&E's holding company and affiliate relationships, and in 1998 and 1999 they audited administrative and general expenses in connection with PG&E's general rate case. In 1999, Overland performed an audit of Roseville Telephone Company's affiliate transactions and non-regulated activities, and in 2000 submitted

²⁷ *Id.*, *mimeo.*, at 10 and conclusion of law 8.

²⁸ Exh. 2A:402 at 1-2 & Attachment GCH-1, at 1 (Phase 2A, Harpster Opening Testimony).

testimony concerning Roseville's IEMR earnings calculations. Since 2000, Overland has performed the regulatory audit of Pacific Bell.²⁹

2. Generally Accepted Auditing Standards

We also find no merit in Pacific's allegation that Overland failed to conduct the audit in accordance with Generally Accepted Auditing Standards (GAAS) because (1) Overland's auditors lacked adequate technical training and proficiency as auditors, (2) Overland failed to exercise due professional care, and (3) Overland conducted its audit in a biased manner.

GAAS are promulgated by the American Institute of Certified Public Accountants (AICPA). GAAS include 10 broadly phrased sets of standards and general principles that guide the audit function. They are classified as general standards, standards for fieldwork and standards for reporting. For example, General Standard No. 1 provides: "The examination is to be performed by a person or persons having adequate technical training as . . . auditor[s]."

Overland and its personnel were qualified to conduct the audit for the previously stated reasons.

3. NARUC Requirements

Pacific also claims that Overland represented to the Commission that it would perform its audit in conformity with certain unspecified standards of NARUC, the National Association of Regulatory Utility Commissioners. The one NARUC standard Pacific claims Overland violated states that "[t]he consulting firm should present draft reports, consistent with the client's requirements, in

²⁹ Exh. 2A:400 at 3 (Phase 2A, Welchlin Opening Testimony).

order to afford the client and the auditee the opportunity to make pertinent comments and factual corrections wherever necessary, and to allow for the discussion of conclusions and recommendations before a final report is prepared.”

At hearing, Overland’s witness testified that the reference to NARUC standards in its proposal letter was a word processing error that resulted when Overland reused an earlier proposal draft.³⁰ The record is unclear as to what extent, if any, the Commission relied upon the proposal letter. The Commission was silent on whether or not the audit was to be carried out consistent with any NARUC standards. The alleged violation is also somewhat mitigated by the opportunities for Pacific to dispute the audit findings, both at hearing and in subsequent briefing. It remains troubling that Overland would commit to following audit procedures recommended by our professional association and then fail to follow them. It is certain that this failure contributed to the rancor that was so much a part of this proceeding. Nevertheless, this failure has no significant bearing on the facts or substantive conclusions reached in this proceeding.

4. Policy Discussions

Pacific also complains that the auditors engaged in detailed policy discussions, allegedly in violation of the audit standards. It is indeed true that D.96-05-036 states that the “work product [of the audit] should not include

³⁰ 10 RT 984:1-986:2.

lengthy policy discussions”³¹ However, the Commission said in the same decision that, “The [audit report] should include an analysis of all issues uncovered, including any relevant documentation Recommendations as to specific accounting measures would also be welcome.” We also asked for “a thorough, aggressive audit.”³² We therefore interpret our instructions to include more than simply pointing out errors. Rather, we expected the auditors to suggest means of resolving problems

Many of the items Pacific identifies as “lengthy policy discussions” relate directly to accounting measures and therefore are entirely within the letter of the Commission’s order. One Overland recommendation relates to the Commission’s “authority to set accounting . . . standards,” another relates to “remov[ing] parent billings . . . from regulated expenses,” a third relates to whether affiliates should collect sales referral fees when they provide referral services to Pacific’s customers, a fourth relates to “treatment of costs associated with . . . services marketed to customers outside . . . Pacific’s local exchange territory,” and a fifth relates to “treatment of costs incurred to enter the long distance market.”³³ The points Overland makes are entirely consistent with the requirement of “an analysis of all issues uncovered,” and “[r]ecommendations as to specific accounting measures.”

³¹ D.96-05-036, 66 CPUC 2d 274, 279 (1996).

³² *Id.*

³³ Pacific Opening/Audit at 20-21.

We note, however, that it is the Commission that has the final word on interpreting its past decisions and on determining whether a practice complies with Commission policies.

5. Pacific's Allegation Concerning Errors by Overland

Finally, Pacific criticizes errors in Overland's audit. We note, however, that our hearing procedures provide adequate checks that permit the correction of specific errors.

IV. Undisputed Audit Adjustments

As ORA points out, "Pacific has conceded at least 20 out of the 72 audit adjustments, at least to the extent of agreeing that [the] accounting treatment it used for . . . purposes of its IEMR [Pacific's California earnings report] was incorrect."³⁴ The undisputed issues relate to expenses Pacific incurred in shutting down its Advanced Communications Network; its sale of Bellcore; and parent SBC's political and legislative influence expenditures, its charitable contributions, memberships and foundation expense, among others.

A chart listing the undisputed items appears as Appendix D to this decision. Pacific shall make all IEMR changes reflected in that Appendix and reflected more fully in the audit report. Pacific shall include in its compliance Advice Letter filing, due within 90 days of the effective date of this decision, schedules that identify each of the undisputed audit adjustments and demonstrate that Pacific has properly reflected the ordered adjustments in its financial reporting.

³⁴ ORA Opening/Audit at 10.

These undisputed audit adjustments have the following consequences:

V. Disputed Audit Adjustments

We discuss the disputed audit adjustments in the same order as Overland discussed them in the audit report, as follows:

- Issues affecting Pacific's Revenues and Other Operating Income
- Issues affecting Operating Expense
- Employee Benefits
- Depreciation Accounting
- Income Taxes
- Net Plant
- Other Rate Base Items
- Affiliate Transactions
- Regulated and Nonregulated Allocation

While the parties did not all agree that this was the appropriate order in which to discuss the issues, or even that any particular issue "belonged" under a particular category, they all agreed on a joint outline arranged in this order. Thus, for ease of understanding, we use the outline as well.

After discussing the foregoing specific audit adjustments, we discuss the following four issues:

- NRF Monitoring (items for consideration in Phase 3 of the proceeding)
- Whether Pacific Impeded the Audit
- Phase 2 Remedies
- Recovery of Audit Costs

A. Revenue and Other Operating Income**1. Contingent Liabilities**

Overland's recommended adjustment for contingent liability accruals reduces operating expenses by almost \$103 million, on an intrastate pre-tax basis, during the audit period.³⁵ The accruals result from Pacific's estimates of future anticipated expenses related to lawsuits and regulatory proceedings. Overland claims that is unable to substantiate these accruals with the documentation provided by Pacific.

Among other supporting documentation, Overland requested the specific basis for Pacific concluding a liability existed and the basis for determining the amount of the liability. Pacific did provide Overland over 4,900 documents to support the contingent liability accruals. The documents included case identifications, pleadings from the underlying proceedings, narrative discussions of issues and a description of the process utilized for determining contingent liability accruals.

Pacific claims that these non-privileged documents are sufficient for an analysis of its contingent liability accruals. Overland disagrees. Overland disallows all such accruals as unauditable, replacing the accrued amounts with actual payouts where available and with nothing where no such payouts occurred.

³⁵ This discussion refers to issues referenced as index 1, 10, 68 and 69 in Appendices A, B, C and D.

Pacific objects to furnishing further documentation supporting its decisions on how and why to post accruals for these liabilities, citing the attorney-client privilege. Pacific argues that these documents reveal communications from its attorneys on how and why accruals are posted for the liabilities. TURN and ORA alternatively argue that the documents are not privileged, Pacific impliedly waived the privilege, and even if the information was privileged, release of it would not waive the privilege as to the claimants in the relevant legal and regulatory proceedings.

Application of the privilege shields information which may very well create obstacles for Overland; however, the California Supreme Court has determined that the Commission cannot compel the disclosure of attorney-client privileged information.³⁶ The broad powers granted to the Commission under the Constitution do not exempt it from complying with the attorney-client privilege.³⁷

Discovery disputes over the attorney-client privilege have dogged the Commission's audit process. For example, in the *Matter of the Application of Pacific Bell*, the audit was suspended to resolve a discovery dispute over the attorney-client privilege.³⁸ Pacific objected that many of the documents the audit team which to review were protected by the attorney-client privileged. After

³⁶ *Southern Cal. Gas Co. v. Public Utilities Com.* (1990) 50 Cal.3d 31, 37.

³⁷ *Id.* at 39.

³⁸ D.92-07-076, Finding of Fact no. 4.

conducting an in camera review of the disputed documents,³⁹ the administrative law judge sustained in part Pacific's objection based on attorney-client privilege.

³⁹ Generally, the courts cannot compel disclosure *in camera* to rule on the privilege. *Moeller v. Sup. Ct.* (1997) 16 C.4th 1124, 1135. However, the rule is not absolute. A litigant may still have to reveal some information in camera to permit the court to evaluate the basis for the claim *Id.*

We disagree with TURN and ORA that information is not privileged. GAAP requires the accrual of contingent liabilities. The difficulty presented by the contingent liability accruals is that due to the nature of the accruals, the determination of the accrual amount necessarily involves some privileged communications.

We also disagree with TURN and ORA that waiver of the attorney-client privilege occurred here. Pacific has done nothing in the present proceeding to place at issue its privileged communications. Merely revealing that one has consulted an attorney is not enough to waive the privilege.⁴⁰ The fact that the Pacific's accruals are at issue does not place in issue its attorneys' state of mind or their advice. Nowhere in this proceeding does Pacific state that it intends to rely on its attorneys' advice or state of mind to support the contingent liability accruals.

Rather, Pacific maintains that its accruals are supported by the non-privileged documentation. We can determine whether the accruals are substantiated based on the non-privileged documentation. Pacific has made its showing absent disclosing its actual legal advice. If we conclude, after considering the documentation that Pacific has not supported its accruals, we can disallow the expenses. Pacific does not, however, impliedly waive its privilege if it simply fails to make an adequate showing.

In sum, the Commission cannot compel the disclosure of privileged information. Pacific has not waived the privilege because its attorneys' advice or

⁴⁰ *Mitchell v. Superior Court* (1984) 37 Cal. 3d 591, 609.

state of mind is not in issue. We are then left with Overland's inability to verify the correctness of the contingent liability accruals. Overland states that it would violate GAAS for it simply to accept Pacific's claimed accruals without further documentation. More importantly, with the non-privileged documentation provided by Pacific, Overland found that the some of accruals appeared to be unjustified.

We thus conclude based on Pacific's refusal to disclose the relevant information to Overland that the Commission lacks a sufficient record to justify the booking of these expenses on an accrual basis. We agree with Overland that Pacific's contingent liability accruals should be reduced in accordance with the audit recommendation. As shown in Appendix A, we adopt the intrastate regulatory after-tax adjustments of \$52.8 million in 1997, \$1.1 million in 1998, and \$7.0 million in 1999 for contingent liabilities – Operating Expense. We also adopt the audit adjustment of \$8.7 million for PIU Accrual, \$13.7 million for USOAR Rewrite, and \$24.0 million for contingent liabilities – Revenues for 1997 on an intrastate regulatory after-tax basis as shown in Appendix A.

2. Uncollectible Revenues and Settlements

In 1996, Pacific implemented a new automated bill collection system called the Revenue Collection Risk Management System (RCRMS). Overland states that as a result of problems that Pacific agrees occurred with RCRMS, Pacific's uncollectible revenues and its uncollectible settlements with contract billing

customers were overstated during the audit period.⁴¹ Pacific incurred additional uncollectibles in 1996 principally because RCRMS had an error that prevented nonpaying customers from having their telephone service disconnected. Thus, Pacific incurred significant bad debt and related write-offs because nonpaying customers continued to have service. Had the accounting for uncollectible revenues and expenses related to RCRMS been correctly posted in 1996, rather than when Pacific recognized and corrected the problem in subsequent years, Pacific would have had higher potentially shareable earnings in 1997, 1998 and 1999. Overland states that intrastate uncollectibles revenues were overstated by \$53.5 million in 1997.⁴² In addition, because Pacific failed to accrue additional uncollectibles for AT&T, MCI, Sprint and other contract billing customers in the year it recognized the RCMRS problems, intrastate uncollectible settlement expenses were overstated by \$42.1 million during the audit period ⁴³

The dispute is over when Pacific should have accrued the additional uncollectible revenue and settlement expenses – in 1996, when the RCRMS problem was discovered and corrected, or in subsequent years. ORA contends Pacific was well aware of the problems in 1996 and should have accrued the expense in that year. Pacific agrees that it was aware of problems with RCRMS

⁴¹ This discussion appears in the revenue section of this decision because Overland included it in the revenue portion of the audit report. This discussion refers to issues referenced as index 3 and 13 in Appendices A, B, C and D.

⁴² Exh. 2A:404 at 5-17 (Audit Report)

⁴³ Exh. 2A:404 at 6-37 (Audit Report)

in 1996,⁴⁴ but contends it did not realize the magnitude of the problem from an expense perspective until 1997, and therefore appropriately booked the expenses in 1997. In addition, because Pacific failed to accrue additional uncollectibles for AT&T, MCI, Sprint and other contract billing customers in the year it recognized the RCMRS problems, intrastate uncollectible settlement expenses were overstated by \$42.1 million during the audit period.

While Pacific's bad debt write-offs shot up in November and December 1996 – a fact ORA's witness Michael Brosch found to be evidence that Pacific should have accrued an amount for estimated bad debts that year – Pacific claims there were also significant decreases in the July-September 1996 period. The numbers effectively offset each other, masking the problem, Pacific contends.

Evidence in the record contradicts Pacific's claim and shows that other than in the period in 1996 at issue, Pacific's bad debt did not fluctuate drastically as it did during that period. The fluctuation put Pacific on notice of a serious problem in 1996, and Pacific should have taken action to accrue an amount for estimated bad debts in that year.

Pacific's collections history shows a fairly even ebb and flow of net bad debt from January 1995 through August 1996, when the percentage of accounts showing net bad debt ranged from a high of approximately three percent to a

⁴⁴ Pacific Opening/Audit at 47.

low of approximately one percent. The trend never lasted more than two months in any one direction – up or down – during that period.⁴⁵

In contrast, the rate of bad debt soared steadily from August 1996 to the end of the year. The graphic depiction of this debt showed a line headed steadily upward from a low of one percent in August 1996 to a high of five percent in December 1996. Never again through December 1997 was the volatility nearly as great. Moreover, Pacific's own internal document dated July 23, 1996 showed Pacific was well aware of a number of financial problems stemming from the RCRMS system as of that date.⁴⁶

The evidence was plain that Pacific had a significant problem in 1996, and it should have recorded the expense that year. Had it done so, rather than carrying the 1996 expense forward to 1997, it would have reported lower expense, and higher potentially shareable earnings in 1997. We therefore agree with the audit that Pacific should have recorded RCRMS-related expenses in 1996 rather than 1997. Pacific should make the recommended audit adjustment and restate its 1996 books as well. The adopted intrastate regulatory after-tax amounts for the uncollectible settlements are \$16.6 million in 1997, \$7.8 million in 1998, and \$512,000 in 1999. We also adopt the audit adjustment of \$53.5 million in 1997 for uncollectible revenues on an intrastate regulatory after-tax basis as shown in Appendix A.

⁴⁵ See Exh. 2B:369.

⁴⁶ Exh. 2B:120 at 14:3-19 (Brosch Opening Testimony, citing Pacific's discovery responses).

3. Directory Publishing

The remaining issue with revenue impact relates to how Pacific Bell Directory accounted for its revenues (and expenses) during the audit period. Prior to the fourth quarter of 1996, Pacific accounted for revenues and expenses over the life of the directory. In 1996, it changed its policy to “conform to the policies of SBC,”⁴⁷ and began recognizing revenue and expense when the directory is issued.

Overland stated it could not determine whether the change had an impact on 1997 revenues and expenses, and we do not find that there is any need to pursue the item further. Pacific correctly recognized a one-time pre-tax gain of \$143 million in 1996. The extensive audit could not establish that there were any effects in 1997 for which Pacific failed to properly account.

B. Operating Expenses

1. Local Number Portability Costs

a) Introduction

Overland found that Pacific did not properly account for its local number portability (LNP) costs,⁴⁸ citing two separate reasons. First, it claimed Pacific should have deferred these costs – required by the Telecommunications Act of 1996 (1996 Act) and the FCC – as a regulatory asset (to be amortized over a longer period supported by rates), rather than booking such costs as an

⁴⁷ Pacific Opening/Audit at 50.

⁴⁸ This discussion refers to issues referenced as index 5 and 70 in Appendices A, B, C and D.

immediate expense.⁴⁹ Deferral would have reduced operating expenses – and increased earnings potentially shareable with ratepayers – by \$171 million on an intrastate pre-tax basis during the audit period.⁵⁰

Costs that are deferred as a regulatory asset do not appear on the IEMR as an expense. Because lower expenses increase earnings – and, potentially, sharing – while regulatory assets have little impact on earnings, the difference between an expense and a regulatory asset has great significance to Pacific’s IEMR.

TURN adds that “as of early 1996, the Commission made it clear that at least some portion of costs incurred to implement local number portability was probable of recovery as an allowable cost for ratemaking purposes.”⁵¹ Pacific contends that Overland and TURN are incorrect that the criteria for deferring the costs as a regulatory asset were met at any time before a July 16, 1999 FCC order⁵² concluding its investigation of the long-term number portability tariff

⁴⁹ The LNP requirement, implemented in several FCC decisions, stemmed from the 1996 Act, and obligated Bell Operating Companies such as Pacific to advance the ability of users of telecommunications services to retain, at the same location, existing telecommunications numbers without impairment of quality, reliability, or convenience when switching from one telecommunications carrier to another. *See* 47 U.S.C. § 251(b)(2).

⁵⁰ Exh. 2B:415 at S6-2 (Supplemental Audit Report).

⁵¹ TURN Opening/Audit at 15.

⁵² Pacific Opening/Audit at 53, citing Exh. 2B:334 at 14 (Wells Direct Testimony). The Wells testimony cites *In the Matter of Long-Term Number Portability Tariff Filings*, CC Docket No. 95-35, *Memorandum Opinion and Order*, FCC 99-158, ¶ 1 (rel. July 16, 1999).

transmittals. Pacific argues that to defer LNP costs would have violated the requirements of Statement of Financial Accounting Standards (SFAS) No. 71,⁵³ which governs deferral of costs as a regulatory asset.

Second, Overland stated that LNP expenses were not even relevant to Pacific's California expense reporting. Overland noted that "[t]he FCC has affirmatively and directly asserted jurisdiction over the LNP costs recovered through the FCC tariff," and concluded that "the costs . . . should be assigned directly to the interstate jurisdiction."⁵⁴ Overland cited a May, 1998 FCC order in support of its conclusion.⁵⁵ Using a jurisdictional separations approach, Overland found that Pacific never should have reported LNP costs as intrastate expenses on its IEMR.

Pacific contends that the only issue is the state-federal jurisdictional separations, not the deferral of costs as a regulatory asset: "the dispute regarding the assignment of LNP costs boils down to a dispute regarding the timing of the [jurisdictional] separation of the costs [between the federal, or interstate, and California, or intrastate, jurisdictions]."⁵⁶ Once the FCC decided that LNP costs should be characterized as 100% interstate, Pacific states, the costs should have

⁵³ FAS 71 prescribes the appropriate accounting for the effects of certain types of regulation. A complete copy of FAS 71 appears in the record as Exh. 2B:191.

⁵⁴ *Id.* at S6-1.

⁵⁵ *In the Matter of Telephone Number Portability*, CC Docket No. 95-116, *Third Report and Order*, FCC 98-82 (rel. May 1998).

⁵⁶ Pacific Opening/Audit at 53.

moved off the IEMR books and onto the federal books. Pacific agrees that the FCC's May 1998 order should have triggered this change.⁵⁷

We adopt the adjustment as proposed by Pacific – only after May, 1998 should the LNP costs be removed from the intrastate regulated books. We do not agree with Overland that it was appropriate for Pacific to record an intrastate regulatory asset for LNP costs during the audit period. For the reasons discussed below, LNP costs did not meet the requirements of SFAS No. 71.⁵⁸

**b) Criteria for Deferral as a Regulatory Asset – FAS
71**

Paragraph 9 of the FAS 71 requirements provides that a regulated enterprise shall capitalize (defer as a regulatory asset) **all or part** of an incurred cost that would otherwise be charged to expense if both of the following criteria are met:

- a. It is probable that future revenue in an amount at least equal to the capitalized cost will result from inclusion of that cost in allowable costs for rate-making purposes.
- b. Based on available evidence, the future revenue will be provided to permit recovery of the previously incurred cost rather than to provide for expected levels of similar future costs.

If the “part” of the cost deferred is tied to a specific cost and probable of recovery, Pacific believes it is appropriate to record a regulatory asset. Pacific

⁵⁷ *Id.*

⁵⁸ FAS 71 prescribes the appropriate accounting for the effects of certain types of regulation. A complete copy of FAS 71 appears in the record as Exh. 2B:191.

reasons that SFAS 71 requires not only that the costs being deferred be “probable” of recovery, but also that the costs be identifiable:

If the amount of the incurred cost to be capitalized is unspecified, or if specified, not probable of future recovery, then none of the costs can be deferred as a regulatory asset. Additionally, at the time the regulatory asset is created, the future revenue authorized by the regulatory authority must relate specifically to the previously incurred costs.⁵⁹

Pacific argues that the failure of either of these elements is fatal to the creation of a regulatory asset. Pacific explains that its inability to record a regulatory asset for LNP costs resulted from the fact that there was no specific cost which was probable of recovery. TURN contends that FAS 71 does not require that a utility know the amount of probable recovery when it makes the decision to defer a regulatory asset.

After FAS 71’s issuance, FAS 90 refined the definition of “probable” by making it consistent with FAS 5. FAS 5 defines something as “probable” if it meets the first of two conditions:

- a. Information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements. [footnote omitted]. It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of the loss.
- b. The amount of loss can be reasonably estimated.

⁵⁹ Uffelman Reply Testimony, Exh. Pacific: Phase 2B:337, at 5-6.

TURN reasons that since the term “probable” only appears in paragraph (a) of SFAS 5, only paragraph (a) should be read into SFAS 71. According to TURN, “if *any* amount is probable of recovery, [SFAS] 71 mandates creation of a regulatory asset.”⁶⁰ TURN’s interpretation appears to be that the only time it is appropriate not to record a regulatory asset is where the amount of cost probable of recovery is zero.

We agree with Pacific’s analysis of SFAS 71. Guidance is provided by the SEC’s Division of Corporate Finance:

Under SFAS 71, a utility may defer certain costs of providing services if the rates established by the regulators are designed to recover the utility’s **specific costs** and the economic environment gives reasonable assurance that those rates can be charged and collected through the periods necessary to recover the costs.⁶¹

Chapter 12 on Rate Regulation and GAAP of Accounting for Public Utilities also states:

Evidence that a regulatory asset is probable of recovery is a matter of professional judgment based on the facts and circumstances of each case. The SEC has increasingly scrutinized documentation of the basis of recording regulatory assets.⁶²

⁶⁰ TURN Opening/Audit at 9.

⁶¹ Securities Exchange Commission’s Division of Corporate Finance, *Frequently Requested Accounting and Financial Reporting Interpretations and Guidance*, March 31, 2001;.

⁶² Rate Regulation and GAAP of Accounting for Public Utilities, Section 12.07[1], at 12-29.

We find that the prerequisites for Pacific to defer the LNP costs as a regulatory asset were not met. There was significant uncertainty surrounding potential recovery for LNP costs. The FCC did not issue its Cost Classification Order until December 14, 1998, and the FCC did not conclude its investigation of the long-term number portability tariff transmittals until July 16, 1999. In the proceeding leading up to the decision, the Commission requested that local commissions be allowed to determine the system by which LNP costs were to be recovered. That the Commission deemed some cost recoverable does not obligate Pacific to guess what the amount may be and record a regulatory asset in that amount. The only relevant inquiry then for the treatment of LNP costs is whether the costs should have been jurisdictionally separated.

Finally, we note that as a policy, this Commission must adopt a strict and clear definition of what constitutes a regulatory asset. Failure to distinguish those situations in which the Commission clearly intends to create a regulatory asset from those in which the Commission simply leaves open the possibility of cost recovery is a prescription for regulatory trouble. In particular, a regulatory policy that finds that a regulatory asset exists even when the Commission only offers a chance of cost recovery would undermine the financial community's confidence in those regulatory assets that the Commission intends to create.

c) Jurisdictional Separations

Again, we find that as of May 1998, when the FCC issued its Third Report and Order, Pacific should have recovered all of the expense related to LNP exclusively in the federal jurisdiction. Pacific agrees that the May 1998 FCC order triggered an allocation of 100% of the costs to the interstate jurisdiction: "By May 1998, it was determinable that the FCC intended LNP costs to be fully

allocated to the interstate jurisdiction. . . .”⁶³ Thus, Pacific should not have reported any LNP costs on its IEMR after the May 1998 FCC order.

d) Conclusion

In summary, Pacific should have charged all LNP expense to the federal jurisdiction as of the FCC’s May 1998 order on LNP cost recovery. Pacific should modify its IEMR to remove all LNP costs, including plant and depreciation, from reported intrastate results of operations from May 1998 forward. The intrastate regulatory after-tax adjustment for the LNP costs is \$15.6 million in 1998 and \$22.3 million in 1999.

2. Local Competition Implementation Costs

The auditors also found that Pacific improperly included \$49 million on an intrastate pre-tax basis in local competition implementation costs in its operating expenses for 1997 and 1998, and that Pacific should have deferred such costs as a regulatory asset for future recovery.⁶⁴ Removing such cost from expense would have raised the amount of earnings subject to sharing in those years. As with the LNP issue, a SFAS 71 analysis is appropriate for evaluating the treatment of local competition costs.

Pacific claims it never had the certainty it needed – probability of recovery of each specific cost it incurred – and therefore never was required to defer an asset. Once again, TURN claims that SFAS 71 provides only that recovery of a

⁶³ Pacific Opening/Audit at 53.

⁶⁴ This discussion refers to issues referenced as index 6 in Appendices A, B, C and D.

category of cost must be probable, not that management be able to estimate the full amount of recoverable costs.

TURN claims the SFAS 71 regulatory asset deferral requirement was met even earlier than does Overland. Overland cites a 1998 Commission decision, D.98-11-066,⁶⁵ as the basis for creating a regulatory asset. TURN, on the other hand, claims that earlier Commission decisions are at least as relevant as the 1998 decision. TURN states that “[a]s of the issuance of D.96-03-020⁶⁶ [in 1996], it was probable that Pacific Bell would recover some amount greater than zero. And under SFAS 71, a regulatory asset should have been established.”⁶⁷ In D.96-03-020, TURN’s cited case, the Commission stated,

[W]e conclude that reasonably incurred costs to implement competitive local exchange service are appropriate, and it is not unreasonable that end-users pay for such costs. . . . We shall consider establishing an end-user surcharge for certain reasonably incurred implementation costs at a later date We will, however, authorize Pacific . . . to establish a memorandum account to record actual implementation costs incurred on and after January 1, 1996. . . .⁶⁸

Finally, in D.98-11-066, the case Overland cites, the Commission adopted an interim surcharge to allow for immediate recovery of specific types of implementation costs, subject to refund after a reasonableness review.⁶⁹ Pacific

⁶⁵ 1998 Cal. PUC LEXIS 978.

⁶⁶ 1996 Cal. PUC LEXIS 257.

⁶⁷ TURN Reply/Audit at 17-18.

⁶⁸ D.96-03-020, 1996 Cal. PUC LEXIS 257, 65 CPUC 2d 156, 167 (1996).

⁶⁹ D.98-11-066, 1998 Cal. PUC LEXIS 978, 83 CPUC 2d 183, 193-94 (1998).

claims that D.96-03-020,⁷⁰ D.97-04-083⁷¹ and D.98-11-066⁷² provided it no assurance of cost recovery. It also claims that a later decision – D.00-09-037⁷³ – approving a settlement regarding the actual costs Pacific would recover, likewise provided no basis to record a regulatory asset. Pacific asserts that each of these decisions contains limitations on Pacific’s right to recovery, rendering it impossible to determine as a result of any of the decisions that it was appropriate to defer a regulatory asset.

Overland’s reliance on the interim cost recovery authorization in D.98-11-066 is misplaced. As noted by Pacific, the Commission, in D.00-09-037, stayed the authorization to recover these costs pending the resolution of rehearing applications that challenged the authorization of interim cost recovery. It was not until September 2000, in D.00-09-037, that an amount for local competition cost recovery was authorized.

We are likewise not persuaded by TURN’s analysis. D.96-03-020 authorized Pacific to establish memorandum accounts for “possible” recovery, but it concluded that “[n]o cost recovery for implementation costs should be approved at this time.”⁷⁴ The Commission in D.00-09-037 later confirmed that its 1996 decision had determined “it was premature at that point to authorize any

⁷⁰ 1996 Cal. PUC LEXIS 257.

⁷¹ 1997 Cal. PUC LEXIS 495.

⁷² 1998 Cal. PUC LEXIS 978.

⁷³ 2000 Cal. PUC LEXIS 697.

⁷⁴ D.96-03-020, 65 CPUC2d 256, 214.

implementation cost recovery.”⁷⁵ D.98-11-066 similarly determined that it was “premature to authorize any specific cost recovery allowance for implementation costs at this time”⁷⁶

Under the FAS 71 standard we discuss in connection with LNP costs, Pacific properly expensed the audit amount of \$49 million.

3. Merger Savings

The audit and ORA differ on how to account for a ratepayer refund that came about as a result of Pacific Telesis’ 1996 merger with SBC.⁷⁷ The audit recommends a \$35 million reduction in intrastate operating expenses to reflect the CPUC-ordered allocation of merger savings between ratepayers and shareholders. Pacific made IEMR ratemaking adjustments to reflect the merger savings allocation in 1998 and 1999. The audit modifies Pacific’s adjustments to correct claimed errors and, in the auditors’ view, more accurately reflect the timing of the ordered merger savings.

With the exception of agreed-upon small corrections needed to reduce IEMR expenses by \$4.2 million on a Pacific total company basis both in 1998 and 1999,⁷⁸ ORA and Pacific oppose this audit adjustment in favor of Pacific’s accounting approach. In 1997, Pacific recorded in its books a large expense accrual on the actual amount of the refund (in present value terms, \$213 million

⁷⁵ D.00-09-037, mimeo, p.2.

⁷⁶ D.98-11-065, mimeo, p. 33.

⁷⁷ This discussion refers to issues referenced as index 7 in Appendices A, B, C and D.

⁷⁸ See Pacific Opening/Audit at 67; ORA Opening/Audit at 31.

in payments to ratepayers over nine years and \$34 million in contributions to a Community Partnership). Then, Pacific reversed this accrual as an offset in subsequent years, so that the business recognized approximately \$50 million per year pursuant to the Commission's merger order. We find that Pacific's accrual was proper.

We agree with ORA that we should not adopt Overland's contrary approach to the accruals. Overland assumed that Pacific would have realized savings as a result of the merger, and imputed those savings to the business, lowering its reported expenses. Because shareholders funded half of the merger refund, Overland assumed that shareholders should receive 50% of the imputed savings. However, ORA claims Overland's approach is based on "phantom" savings figures and that there is no proof that these savings actually materialized.⁷⁹

We agree with ORA and Pacific that there is no evidence in the record that the savings Overland assumed ever came about. Thus, there should have been no assumption that ratepayers would lose the 50% of imputed savings Overland decided should inure to the benefit of Pacific's shareholders. We reject the change recommended by the audit, but do adopt the \$2.5 million and \$2.5 million conceded adjustments for both 1998 and 1999 respectively on an intrastate after-tax basis as shown in Appendix A.

⁷⁹ For a detailed discussion of these issues, *see* Exh. 2B:120 at 16-25 (Brosch Opening Testimony).

4. Software Buy-Out Agreement

In December 1999, Pacific accrued \$55.7 million in operating expenses for the buy-out of its existing obligation to make future payments into 2003 to Lucent for software right-to-use fees. The buy-out was effected through an amendment of Pacific's existing contract with Lucent, replacing Pacific's obligation to make quarterly payments for the contract period (October 1, 1999 through June 30, 2003) with a one-time payment of \$55.7 million. All other terms and conditions of the existing contract remained in effect.⁸⁰

⁸⁰ Exh 2A:404 at 6-31 (Audit Report).

It is Overland's opinion that the transaction was only a financial restructuring of the existing contract, and should have been recorded as a "prepayment" rather than an expense pursuant to FCC Part 32 rules.⁸¹ Overland recommends reducing Pacific's 1999 expenses by \$44 million.

Pacific contends that it canceled that existing contract and entered into another contract for perpetual use of the software. It claims that the new contract was properly expensed rather than charged as a prepayment in accordance with Pacific's 1998 10-K filing with the SEC in which it stated that "[t]he costs of computer software purchased or developed for internal use are expensed as incurred."

Overland also cites as the basis for its opinion Section 32.1330 of FCC Part 32,⁸² which requires that prepayments be amortized to the appropriate expense account over the term of the prepayment. Pacific disagrees with Overland, and claims that its accounting treatment was consistent with FCC Part 32 Rules that were in effect at the time of the purchase.⁸³

We disagree with Overland's view on this matter. The substance of the transaction was not an advance payment of an operating expense in exchange for a price reduction. Under the terms of the contract, Pacific purchased a perpetual software license from Lucent with payment terms that were contingent upon the number of access lines utilizing the relevant switch software. The amendment

⁸¹ This discussion refers to issues referenced as index 9 in Appendices A, B, C and D.

⁸² 47 C.F.R. § 32.1330.

⁸³ Exh. 2B: 336 at 14 (Uffelman Opening Testimony).

replaced the contingent payment terms with a fixed fee. Pacific initiated the purchase in 1999 and completed the transaction with the outright purchase of a perpetual right to use the software. We therefore reject Overland's recommended \$44 million adjustment for the year 1999.

5. Incentive Pay Accruals

Overland states that for the years 1997-99, "[i]ntrastate operating expenses are overstated by \$29 million as a result of the over-accrual of incentive pay costs."⁸⁴ Actual incentive pay was lower than the accrued amount, and it is the difference between the accrual and the actual payout that Overland seeks to remove from expense. Pacific trued up the difference in the year following the accrual, and contends Overland's proposal – to adjust the accruals in the year they were made to reflect actual payouts – would violate GAAP.

Pacific does not deny there was a difference between the accrued amount and the actual payout; it only disagrees on the timing of the true-up. Although GAAP does not preclude retroactive changes to the IEMR books, we agree with Pacific that it acted prudently in following GAAP, which recommends true-up when the issue is resolved and prohibits the restatement of past periods. Moreover, Pacific's estimate, while in error, was reasonable.

6. Other Expense Related Issues – "Royalty Payment"

Overland notes that in 1998 Pacific allocated a \$30 million parent company "management fee" among regulated expense accounts. According to Overland,

⁸⁴ This discussion refers to issues referenced as index 11 in Appendices A, B, C and D.

the transaction “reflects the elimination of royalties Pacific paid to SBC in 1998.”⁸⁵ Pacific contends that Overland mischaracterizes the item as a “royalty payment” when in fact it was an “‘on-top’ adjustment that reclassified certain portions of the parent joint cost allocation related to management fees.”⁸⁶

It appears that the difference of opinion on this matter revolves around how Pacific adjusted the fee out of its intrastate regulated operations, as opposed to whether Pacific made the adjustment. Therefore, there is no dollar adjustment to address here, and we adopt no change based on the audit report.

C. Employee Benefits

1. Other Post Retirement Costs (FAS 112)

In 1997, Pacific recorded a \$9.6 million (on an intrastate pre-tax basis) entry related to pre-1976 disabilities that Pacific’s actuaries had not previously valued. Overland found that Pacific should not have made the entry in 1997, and that it artificially increased expenses by \$9.6 million in that year to the possible detriment of ratepayers.⁸⁷ ORA contends that the catch-up accrual should be removed from the 1997 IEMR results because “SBC Pacific has failed to explain adequately why these pre-1976 liabilities were not known or knowable before 1997.”⁸⁸ It appears that ORA seeks to deny the accrual altogether, rather than

⁸⁵ Exh. 2A:404 at 6-13 (Audit Report).

⁸⁶ Pacific Opening/Audit at 73.

⁸⁷ This discussion refers to issues referenced as index 16 in Appendices A, B, C and D.

⁸⁸ ORA Reply/Audit at 24.

having Pacific record it in its books for the 1970s, based on Pacific's inability to prove the accrual was appropriate.

We agree with ORA that Pacific has not justified why it could not have located this accrual prior to 1997. There is no basis to depress 1997 earnings to correct a supposed error of accrual from the 1970s. Rather, this expense should be written off or charged below-the-line in a way that does not affect ratepayers. We adopt Overland's recommendation of \$5.7 million on an intrastate after-tax basis as shown in Appendix A.

2. Other Employee Benefits Issues

Overland opines that Pacific should be required to provide stand-alone actuarial reports for the Pacific Bell component of SBC benefit plans. Pacific contends this is a costly and unnecessary task, that Pacific was never required to do so when it was part of the Pacific Telesis Group consolidated benefit plans, and that the Commission should deny the Overland suggestion. Overland's motivation is to ensure that the actual Pacific Bell costs – and only those costs – are charged to Pacific Bell expense. We find Overland's suggestion reasonable. Our decision in Phase 2A also orders that Pacific produce stand-alone actuarial reports, and we refer parties to that decision as well.

D. Depreciation Accounting for Intrabuilding Network Cable Amortization

The audit report proposes a \$61.4 million adjustment (\$33.05 million in 1997 and \$28.34 in 1998) to correct errors admitted by Pacific in its accounting for amortization of its intrabuilding network cable investment.⁸⁹ While all sides

⁸⁹ This discussion refers to issues referenced as index 17 in Appendices A, B, C and D.

agree that Pacific made an error, there is a dispute as to when Pacific should have accounted for the error. If it reflects the error only in 1998, the year in which it discovered the problem, ORA claims 1998 expenses will be overstated, and the greater the expenses in 1998, the less the earnings potentially available for sharing with ratepayers. Because the error took place in each of the years 1994-1997, Overland and ORA agree that Pacific should adjust its books in each of these years.

Pacific, in contrast, took a “catch-up accrual” approach: when it discovered it had underdepreciated the cable in the first period of time, it decided to overdepreciate for the second period. Pacific explained that it mistakenly applied the FCC depreciation schedule to the asset, which allows for lower rates of depreciation each year than does the CPUC. It discovered the error in 1997.

While Pacific’s witness, Peter Hayes, admitted that the way Pacific made the adjustment overstated amortization expense in 1997, he claimed that the Commission’s rules did not allow Pacific to make the adjustment in any other way.⁹⁰ He claimed Pacific did not have “depreciation freedom” that would have allowed it to make the depreciation adjustments in prior years.⁹¹ He claimed that Pacific only gained depreciation freedom in connection with D.98-10-026,⁹² in

⁹⁰ 12 RT 1263:2 – 1265:3 (Hayes).

⁹¹ *Id.* at 1271:11 – 1272:3.

⁹² 1998 Cal. PUC LEXIS 669.

which the Commission “chose to discontinue reviewing depreciation rates and accruals.”⁹³

We agree. In 1997, when the error was discovered, Pacific could not adjust its intrastate financial reporting. Pacific did not have the freedom to set its depreciation rates in this manner until January 1, 1999, as a result of D.98-10-026. Pacific was unable to go back and unilaterally depart from the Net Book Value method previously prescribed by the Commission. We find that Pacific acted reasonably and reject the audit’s approach.

E. Income Taxes

1. Accumulated Deferred Income Taxes

Overland found that Pacific overstated the rate base deduction for accumulated deferred income taxes (ADIT) by an average of \$7 million per year due to the improper use of “normalization” accounting. Overland states that the differences between book and taxable income should be accounted for using “flow-through” accounting treatment rather than normalization to the extent allowed by federal tax law.⁹⁴ This issue has implications both for how Pacific accounts for ADIT generally, and for how it does so for the Universal Service Fund.

In our Phase 2A decision, we adopt flow-through tax treatment. For the reasons set forth there, we also adopt such treatment here. The annual rate base

⁹³ 12 RT at 1282:18-26 (Hayes).

⁹⁴ This discussion refers to issues referenced as index 37 in Appendices A, B, C and D.

deductions are \$57.8 million for 1997, \$55.2 million for 1998 and \$43.3 million for 1999 as shown in Appendix A.

2. Sales and Use Tax Accruals

Overland states that for 1997-99, “[i]ntrastate regulated sales and use tax expense is understated by \$857,000 as a result of the reversal of prior period accruals for tax audits.” Overland finds the accruals are unsupported and states that it has not been able to audit them.⁹⁵

Pacific responds that its accruals are neither unsupported nor unauditable and have been recorded in compliance with SFAS 5. As support, Pacific cites “management’s professional judgment - nothing more, nothing less.”⁹⁶

We rejected Pacific’s argument in connection with its contingent liability accruals and also do so here. The purpose of an audit is to test management’s judgments, and to ensure that all accounting transactions that raise questions are verified. Nor is Pacific correct that in all cases, “[w]hen subsequent events indicate that a previously recorded liability has been reduced or eliminated, a reversal is appropriate in the current period.”⁹⁷ Pacific should amend its books for the period in which the transaction occurred if the transaction was “material,” as we define that term in this decision. Even Pacific does not disagree with this premise; it only disagrees as to the meaning of the term

⁹⁵ This discussion refers to issues referenced as index 25 in Appendices A, B, C and D.

⁹⁶ Pacific Opening/Audit at 80.

⁹⁷ *Id.* at 81.

“material.” As we stated in the order commencing the audit, materiality was in the eyes of ORA, but ultimately up to the Commission to decide.

Moreover, even if the change was not material in the period in which the transaction occurred, we do not agree with Pacific that GAAP prohibits the Commission from making a retroactive change to Pacific’s regulatory books in the prior period. These IEMR books are a creation of the Commission, and if a catch-up transaction in a later year skews earnings inappropriately in that year, we believe it is more appropriate to amend the books in the year in which the transaction first occurred.

Thus, in this instance, we agree with Overland that Pacific should have reversed out the sales and use tax accruals in the period in which in originally recorded them, rather than in later periods. We adopt the intrastate regulatory pre-tax audit amount of \$857,000 for the audit period. The intrastate after-tax audit adjustments are \$461,000 in 1997, \$457,000 in 1998 and -\$1.4 million in 1999 as shown in Appendix A.

3. Payroll Tax Correction

Pacific used a computer program to process certain manual paychecks and in so doing failed to generate accruals for the employer’s portion of payroll taxes. Pacific does not dispute that it made an error, but claims that its 1999 catch-up entry to increase other operating taxes by \$9.7 million in that year was all that was necessary to correct the error.⁹⁸

⁹⁸ This discussion refers to issues referenced as index 26 in Appendices A, B, C and D.

Once again, Pacific corrected an error from a prior period in a subsequent year and skewed the actual earnings in the both years. It is consistent with our decision in other respects to require Pacific to make the change to the pre-1999 books. This change will result in the recording of greater expense amounts in 1998 and prior periods. As we have said in other contexts, the Commission may require retroactive changes to the IEMR books, which serve Commission regulatory purposes, regardless of GAAP. The \$9.7 million is the Pacific Bell total company amount. The corresponding amount on an intrastate regulatory after-tax basis is \$4.3 million as shown in Appendix A.

4. Booking of Deferred Taxes

It is Overland's opinion that Pacific overstated its intrastate regulated deferred income tax expenses by \$59 million in 1998 and 1999 on an after-tax basis as a result of an accounting error.⁹⁹

The parties agree there was an error in Pacific's Excess Deferred Tax amortization, so the only disagreement is over how to account for the error.¹⁰⁰ Once again, Overland suggests reflecting the change in the affected year, while Pacific supports making the correction in the year it discovered the error. (Indeed, Pacific made a correcting entry in November 2000.)

As we discuss in several other places in this decision, we disagree with Pacific that GAAP prohibits us from requiring it to make adjustments in the

⁹⁹ Exh. 2A:404 at 9-22 (Audit Report); Exh. 2B:415 at 9-6 (Supplemental Audit Report).

¹⁰⁰ This discussion refers to issues referenced as index 24 and 38 in Appendices A, B, C and D.

affected year.¹⁰¹ This adjustment lowers Pacific's 1998 and 1999 intrastate after-tax expense by an average of \$29.6 million per year as shown in Appendix A. We will require Pacific to adjust the IEMR for the pertinent years to reflect this change. The ratebase adjustments are \$12.8 million in 1998 and \$38.4 million in 1999.

¹⁰¹ See Section entitled "Pacific's Books and Generally Accepted Accounting Principles," above, for the most detailed discussion.

5. Ameritech Severance Accruals

Overland opines that Pacific improperly accounted for current period income tax expense and operating deferred income tax expense related to severance and employee related benefits that were accrued in December 1999.¹⁰² The severance accrual occurred when SBC terminated Pacific Bell employees as a result of SBC's merger with Ameritech.¹⁰³ It is Overland's opinion that Pacific's current period intrastate operating income taxes and intrastate operating deferred income tax expense were each overstated by \$8 million because Pacific should have booked these expenses below-the-line. Overland recommends that Pacific's 1999 IEMR income tax expense be reduced by \$8 million. Overland also recommends that Pacific's 1999 intrastate operating deferred income tax expense be reduced by \$8 million.

Pacific agrees with Overland that it overstated its 1999 current intrastate operating income taxes by \$8 million as a result of the misclassification of the Ameritech severance accrual temporary difference, but maintains that because of normalization accounting there was no effect on the total operating tax expense it reported in the IEMR.

The disagreement centers around the treatment of the income tax effects associated with the severance accrual. Pacific maintains that its normalization income tax policy makes the issue moot because the accounting error misstated current and deferred income taxes by equal and offsetting amounts. Pacific's

¹⁰² This discussion refers to issues referenced as index 22 in Appendices A, B, C and D.

¹⁰³ Exh. 2A:404 at 9-22 (Audit Report).

position is premised on the belief that the Commission will not adopt Overland's income tax policy recommendations from Phase 2A of this proceeding.

There is no disagreement that these costs should have been booked below-the-line. We believe that this issue can be addressed in this order by having Pacific account for the severance accrual and the associated income tax effects on a consistent basis, below-the-line. We direct Pacific to restate its 1999 Commission books to remove the current period and deferred income tax effects associated from the severance accrual from its above-the-line accounts. The intrastate regulatory after-tax amount is \$8.0 million as shown in Appendix A.

F. Net Plant Accounting

1. Property Records

Overland cites three separate documents in support of its conclusion that Pacific does not keep proper track of its plant in service. Overland concludes that based on these documents – either alone or in combination – Pacific has a serious internal control problem in maintaining accurate property records. Because Pacific continues to depreciate plant recorded on its books even if it cannot locate the plant in the field, the problem affects Pacific's financial reporting.

2. FCC Continuing Property Records (CPR) Audit

Overland relies on an FCC audit of Pacific's property records to reach the conclusion that Pacific overstated its recorded plant balances for certain central office equipment. The FCC staff found that Pacific was not able to locate equipment corresponding to 8.4 percent of the sampled items, and found substantive deficiencies in the records for an additional 10.1 percent of the

sampled items. Thus, 18.5 percent of the sampled items did not comply with the FCC's rules for continuing property records.

Pacific contends the FCC's audit recommendations were never adopted and therefore that the audit is an inappropriate basis for Overland's conclusion. The FCC undertook the audit in 1997 as part of an audit of all Regional Bell Operating Companies' central office equipment records. While Pacific criticized the audit after the FCC issued its draft audit report in 1998, its witness conceded that the FCC's decision not to pursue the audit was not due to those criticisms.¹⁰⁴

The question, then, is whether we can respond to an audit that the FCC never concluded or acted upon. We do not believe the record contains enough information about why the FCC did not pursue the audit for us to act upon it. While Pacific's witness tried to depict the FCC's decision not to pursue the audit as a rejection of the audit results, he conceded at hearing that the FCC decision was based more on a changed regulatory environment.

3. Pacific's 1999 Computer Inventory

Pacific also conducted an inventory of its own computer records in 1999 in anticipation of the transfer of its information technology (IT) department to SBC Services. The inventory resulted in \$98 million in plant retirements for plant that could not be found in the physical inventory. Overland states that, "[t]he failure to record retirements on a timely basis is the most plausible, if unproven, explanation for the missing plant."¹⁰⁵

¹⁰⁴ 12 RT 1288:18-1289:14 (Hayes).

¹⁰⁵ Exh. 2A:404 at 10-17 (Audit Report).

The 1999 computer inventory suggests that Pacific lacks adequate controls over its plant and property records.

4. SAVR Retirements

A third document also reflects Overland's concerns with Pacific's plant internal controls.¹⁰⁶ In May 1997, Pacific carried out its own Statewide Asset Verification and Retirement Project (SAVR) to audit its central office property records.¹⁰⁷ The project consisted of a 100 percent physical inventory of 689 Pacific Bell central offices. The SAVR project identified \$414 million of plant that was recorded in Pacific's plant accounts but was not physically present in the central offices. This amount represents 4.5 percent of the investment recorded in Pacific's central office equipment plant accounts.

As with its 1999 computer inventory discussed in the previous section, Pacific found plant records but could not locate the physical plant in the central offices. Pacific therefore retired the unlocated assets from the company's books by crediting plant in service for the original cost of the item and debiting accumulated reserve for depreciation. Pacific also located plant that did not show up in the property records, and made accounting adjustments ("reverse retirements") that were the reverse of what it did for plant it could not locate: debiting plant in service and crediting the reserve for depreciation by an amount equal to the estimated original cost of the discovered plant.

¹⁰⁶ This discussion refers to issues referenced as index 18 and 19 in Appendices A, B, C and D.

¹⁰⁷ *See id.* at 10-12.

Overland states that this process skewed depreciation expense in 1997 and 1998. For the plant that Pacific could not find, Overland calculates that the overstatement amounted to \$17 million on an intrastate pre-tax basis. The dispute relates to whether Pacific should have recorded the changes to its accounting in the affected years, or in subsequent years when it discovered the error. There was an absence of clear guidance from the Commission, the FCC or GAAP at the time of the SAVR retirement accounting.

Once again, Pacific claims that such retroactive adjustments violate GAAP and, therefore, foreclose the Commission's ability to make the retroactive adjustments, a claim we reject as a blanket justification to avoid regulatory scoring of company performance during the years subject to sharing.¹⁰⁸ We therefore reject Pacific's position and adopt Overland's adjustments in connection with SAVR delayed retirements. The intrastate regulatory after-tax audit adjustment of \$5.9 million in 1997 and \$4.2 million in 1998 for the SAVR delayed retirements are adopted as shown in Appendix A.

The "reverse retirements" raise slightly different issues. Here, the concern is that Pacific located equipment for which it had no records. Therefore, Pacific recorded a "reverse retirement" by debiting the plant account and crediting reserve for depreciation in an amount equal to the estimated original cost of the

¹⁰⁸ Concerning Intrabuilding Network Cable Amortization we followed the GAAP procedures because Commission rules affecting depreciation prevented an other plausible accounting treatment.

plant. Pacific recorded \$123.9 million in reverse retirements as a result of the SAVR project.¹⁰⁹

Overland concluded that Pacific's reverse retirement entries unreasonably increased intrastate depreciation expense by \$5.5 million on an intrastate pre-tax basis during the audit period. Overland believed that there was a more plausible explanation for the presence of unrecorded plant than that Pacific simply failed to account for it when acquired. Rather, Overland explained that Pacific either charged the equipment to expense when it acquired it or originally lumped it in with other continuing property record items.¹¹⁰ Yet Overland produced no evidence to support its explanation. We therefore disagree with Overland's approach and reject its recommendation on reverse retirements.

5. Other Net Plant Issues

a) Restructuring Reserve Adjustment

Overland states that intrastate net plant is overstated by an average of \$29 million as a result of an error in Pacific Bell's Restructuring Reserve IEMR ratemaking adjustment.¹¹¹ Overland tried to obtain an explanation from Pacific before writing up its audit findings, but did not receive one until February 1, 2002. However, Overland did not change its conclusion based on the

¹⁰⁹ *Id.* at 10-13.

¹¹⁰ *Id.* at 10-15.

¹¹¹ This discussion refers to issues referenced as index 35 in Appendices A, B, C and D.

new information: “[t]he response to [Overland’s data request] confirms that the correction to net plant recommended in the audit report is proper.”¹¹²

Pacific asserts that Overland’s calculations are wrong because they do not account for more recent activity. However, Overland was not focused on recent activity, but rather on the period 1997-99, and during that period, Overland concluded that net plant was overstated. Since Pacific cites no new reason to change that conclusion, we reject Pacific’s claim. Indeed, Pacific concedes an error of \$4.4 million for each year, reflecting the fact that the “depreciation amounts were keyed in with the wrong sign,”¹¹³ so even Pacific admits that Overland’s finding is partially correct.

Pacific’s explanation does not refute Overland’s audit findings, and we adopt the audit recommendation of \$29.0 million in each of the three audit years as shown in Appendix A.

b) Depreciation Adjustment

Pacific acknowledges that to the extent we adopt any of Overland’s adjustments to depreciation expense, we should also adjust accumulated reserve for depreciation.¹¹⁴ Pacific should reflect this adjustment in the compliance Advice Letter filing it is to make within 90 days of the effective date of this decision.

¹¹² Exh. 2B:415 at S10-3 (Supplemental Audit Report).

¹¹³ Pacific Opening/Audit at 90.

¹¹⁴ This discussion refers to issues referenced as index 36 in Appendices A, B, C and D.

c) Allowance for Funds Used During Construction (AFUDC)

It is Overland's opinion that Pacific's method of calculating its Allowance for Funds Used During Construction (AFUDC) is unreasonable¹¹⁵ and does not logically implement the method adopted for Pacific in Resolution RF-4, which the Commission adopted on November 18, 1980.¹¹⁶ As a result, Overland concludes that Pacific's AFUDC rate is overstated, its intrastate net plant balances are overstated by an average of \$7.9 million, and its intrastate regulated pre-tax depreciation expense is overstated by \$1.7 million for the audit period.

The AFDUC rate reflects the company's average cost of debt, unless a specific new borrowing is associated with the construction of the project. Overland interprets Resolution RF-4 to calculate the cost rate for other externally generated funds as the weighted average cost of new long-term debt and equity securities issues during the past 12 months. During the audit period, Overland found that Pacific ignored new equity issues and based the cost rate solely on the cost of new debt issuances. Overland believes that Pacific's method effectively establishes an AFUDC rate that exceeds a capital structure of 100 percent while RF-4 requires that the capital ratios used to calculate the overall AFUDC rate add up to 100 percent.

Overland found that when Pacific's combined depreciation expense, short-term borrowings, and investment tax credit for a period exceeds its annual

¹¹⁵ This discussion refers to issues referenced as index 71 in Appendices A, B, C and D.

¹¹⁶ A copy of the Resolution is included in Overland's Audit Report (Exh. 2A:404) as Attachment 10-9.

construction expenditures, Pacific considers this negative amount as a negative source of externally generated funds. The result is that this negative amount is treated as a use of capital. Overland maintains that it is illogical to have any amount for externally generated funds when Pacific did not issue any “other externally generated funds” during the construction period.

Citing changes adopted in D.98-10-026, which allowed the use of economic depreciation, Pacific believes it would be appropriate to prospectively allow the same AFDUC rates for intrastate purposes that is used for interstate and external reporting. Pacific agrees that perhaps the intrastate AFUDC rates are overstated but notes that it has consistently applied the Commission’s methodology for the past 20 years. There is no Commission ruling or order disallowing the methodology Pacific employs to implement the Resolution RF-4 AFUDC calculations.

We find that Pacific acted appropriately in calculating AFDUC rates using the same methodology for the past 20 years. Accordingly, we adopt Overland’s recommendation only on a prospective basis. Pacific shall use the Resolution RF-4 AFUDC methodology, as clarified in this decision. We adopt Pacific’s recommendation to use the FCC’s AFUDC rate beginning with the year 2003.¹¹⁷

d) PBOP Pre-Funding Plant Adjustment

Overland states that Pacific’s intrastate net plant is overstated by \$13.3 million for each of the three audit years as a result of an alleged failure by Pacific to account properly for “pre-funding” of post-retirement benefits other than

¹¹⁷ See 47 C.F.R. § 32.2000(c) (FCC Part 32 AFUDC methodology, using average cost of debt unless new borrowing is associated with the construction project).

pensions (PBOP) contributions made prior to the adoption of FAS 106.¹¹⁸

Overland states Pacific should have expensed the contributions as it did for FCC purposes. Pacific claims it could not have done so because prior to the adoption of FAS 106 this Commission did not grant rate recovery of the pre-paid PBOPs; it could only record PBOP expense when it paid for actual PBOP benefits.

There is no evidence in the Phase 2B record on this issue other than the audit itself. Related pre-funding issues are addressed in 2A, where we find that Pacific should have expensed PBOP pre-funding contributions in accordance with Overland's audit recommendation. We find that the PBOP pre-funding contributions raised here should receive the same treatment as the PBOP pre-funding contributions we address in Phase 2A, on the same grounds as set forth in the Phase 2A decision. Therefore, we adopt Overland's recommendation of a rate base adjustment of \$13.3 million for each of the three audit years as shown in Appendix A.

G. Other Rate Base Items

1. Cash Working Capital

The audit report and ORA reached different conclusions about cash working capital.¹¹⁹ Cash working capital is the amount of funds or investment associated with the timing difference between when a utility incurs the costs of providing service and when it receives revenues for those services. If Pacific pays its suppliers before the customer pays for the associated services, cash

¹¹⁸ This discussion refers to issues referenced as index 72 in Appendices A, B, C and D.

¹¹⁹ This discussion refers to issues referenced as index 27 in Appendices A, B, C and D.

working capital is the amount required to finance those expenditures until it receives payment from the customer. (Conversely, if Pacific receives payment for service prior to when it pays its suppliers, cash working capital associated with such a transaction is theoretically a negative amount.)

The Commission's Standard Practice U-16 controls for purposes of calculating cash working capital. Cash working capital requirements typically are calculated through a "lead-lag" study, which compares revenue and expense "lags" to calculate the average annual amount of cash working capital associated with a particular expense category.¹²⁰ Adjustments to cash working capital in this context really are no more than modifications of the assumptions about the lag time between Pacific's payments to and from suppliers.

Overland concluded that because Pacific's lead-lag studies are out-of-date (not updated since 1988), Pacific could not support its lead-lag assumptions. The audit report attempted to determine actual lags by focusing its attention on various items of expense (*e.g.*, deferred income tax expense, amortization expense, as well as one time expenses such as a refund required as a condition of the Pacific Telesis-SBC merger) and on actual revenue lags.

Overland initially concluded that Pacific's corrected working capital requirement averaged \$149 million during the audit period, \$325 million lower than the average amount claimed by Pacific.¹²¹ In its supplemental audit report, Overland changed its recommendations based on new information Pacific

¹²⁰ TURN Opening/Audit at 30-31; Exh. 2A:404 at 11-5 (Audit Report).

¹²¹ Exh. 2A:404 at 11-35 (Audit Report); for a detailed description of the multiple steps Overland used to reach this conclusion, *see id.* at 11-3 – 11-35.

produced in discovery to find that Pacific's revised intrastate cash working capital averaged only \$3 million per year during the audit period.¹²²

ORA and TURN advocate setting the cash working capital figure at zero for the audit period. TURN clarifies that doing so "reflects an assumption that an expense is recovered in revenues concurrent with the incurrence of the expense itself. In other words, a cash working capital figure of zero does not necessarily mean that the expense is being ignored for cash working capital purposes or removed from rate base, but rather that the correct determination of the 'lag' for that expense is zero."¹²³

While Pacific "is open to the possibility of re-examining the Cash Working Capital methodology on a going forward basis and would welcome a simpler calculation," it claims that Standard Practice U-16 precludes the changes the audit, ORA and TURN advocate for the audit period. No party takes issue with Pacific's strict compliance with Standard Practice U-16.

We described Standard Practice U-16 in D.95-12-055: "The Commission's 'Standard Practices' are accounting guidelines which we have used for purposes of ratemaking. They are not rules that the utilities must follow. They are, however, rules that we will follow in developing rates unless the utility can demonstrate 'special circumstances' which warrant a deviation."

We find that no such special circumstances exist here. While Pacific's expense lags have not been updated since 1988, they still reflect the lags

¹²² Exh. 2B:415 at S11-5 (Supplemental Audit Report).

¹²³ TURN Opening/Audit at 31.

experienced during the audit period. It does not follow that because the quantity of transactions increased that actual lag days have changed. The record does not support such a conclusion.

The Commission's Standard Practice U-16 requires the inclusion of non-cash items in working capital. ORA objects to including non-cash items such as depreciation in cash working capital, since these expenses do not actually require Pacific to make a cash outlay. As ORA reasons, "[d]epreciation expenses and other non-cash items are merely accounting entries that have no relationship to a company's required minimum bank deposit. . . . By including these non-cash items in the working cash allowance, SBC Pacific has inflated the rate base."¹²⁴

Excluding non-cash items from cash working capital requirements actually brings that requirement to a negative (below zero) figure. ORA therefore claims that its proposal to set the requirement at zero is actually quite conservative, since it reduces the working capital requirements by less than the amount required to make the working capital figure a negative number.

This reasoning amounts to a proposal for the Commission to abandon its long history of including cash working capital requirements in rate base. This is not to say that we should not take a different approach to the cash working capital requirement in the future. It may well be that Standard Practice U-16 is far too complex and requires reexamination. Pacific proposed a smaller adjustment for cash working capital, and we adopt it here. As shown in

¹²⁴ ORA Reply/Audit at 29, 32, citing Exh. 2B:122, Q&A 20 (Carver Direct Testimony).

Appendix A, the rate base deductions are \$142.2 million in 1997, \$91.3 million in 1998, and \$91.1 million in 1999.

2. Other Rate Base Calculation Issues

Overland found that Pacific made several errors with regard to its rate base calculation. There are six affected items: 1) prepaid directory expenses, 2) prepaid pension, 3) accrued FAS 112 liability, 4) accrued vacation pay liability, 5) accrued FAS 106 liability and 6) accrued contingent liabilities. Overland recommends that four of the items – accrued FAS 112 liability, accrued vacation pay liability, accrued FAS 106 liability, and accrued contingent liabilities – be deducted from rate base, and that the remaining two items – prepaid directory expenses and prepaid pension – be added to rate base.

Pacific opposes Overland's recommended rate base treatment of each item. Pacific does not address the individual items but simply argues that they should not have been included in the calculation of rate base on the IEMR for 1997-99 because they are not included in D.91-07-056.¹²⁵ In D.91-07-056, the Commission ordered that the method and components used to determine the rate base in the calculation of shareable earnings should be the same as those used to determine the rate base used in the start-up revenue requirement in D.89-12-048.¹²⁶

However, D.89-12-048 never specifies what elements comprise rate base. Pacific asserts that the only components that the Commission requires to be included in the rate base calculation are Telecommunications Plant in Service, plus Plant Held for Future Use, plus Materials and Supplies, less Depreciation Reserve, less Tax Reserve, plus Cash Working Capital, but this

¹²⁵ 1991 Cal. PUC LEXIS 439.

¹²⁶ 1989 Cal. PUC LEXIS 633.

interpretation does not come from D.89-12-048. We find that the record is not sufficiently specific on what was in the start-up rate base, and neither D.91-07-056 nor D.89-12-048 provide a detailed listing of the components of it.

Furthermore, rate base must be dynamic in order to accord consistent regulatory treatment to broad categories of rate base, recognizing that the innumerable components of each broad category of rate base (*e.g.*, plant in service, materials and supplies) change over time. Even Pacific “does not support the proposition that rate base should be permanently limited to the rate base items included in the 1989 NRF start-up revenue adjustment”¹²⁷

With these concepts in mind, we turn to the individual items Overland addresses.

a) Prepaid Directory Expense

Overland seeks to add prepaid directory expense to rate base.¹²⁸ Currently, Pacific charges its prepaid directory publishing costs when the directory is published. Overland recommends that the prepaid publishing costs be included in rate base and amortized over the 12-month life of the published directory.¹²⁹

We disagree with Overland’s finding. As noted elsewhere in this decision (*see* Section entitled “Other Revenue/Operating Income Issues – Directory Publishing,” above), Pacific recognizes directory revenues and expenses at the

¹²⁷ Pacific Opening/Audit at 113.

¹²⁸ This discussion refers to issues referenced as index 28 in Appendices A, B, C and D.

¹²⁹ Exh. 2A:404 at 11-28 (Audit Report).

time the directory is published. Overland stated it could not determine whether the change had an impact on revenues and expenses.¹³⁰ Therefore, the record is not adequate to support the change Overland proposes, and we decline to include prepaid directory expense in rate base.

b) Prepaid Pension Assets

Overland opines that Pacific should include prepaid pension assets in rate base. Because the Phase 2A decision deals fully with this issue, we defer to that decision for resolution of the matter.

c) Accrued FAS 112 Liability

Overland seeks to remove this liability from the balance sheet.¹³¹ This change would reduce rate base by the amount of the liability so removed. We agree with Overland that the FAS 112 liability should be removed from rate base.

Pacific recorded its FAS 112 liability in Account 4310.¹³² The FCC requires amounts in that account to be removed from interstate rate base.¹³³ Although FCC accounting methodology is not controlling for our purposes, the Commission often looks to the FCC for guidance. Since there is no controlling precedent of this Commission on the treatment of FAS 112 liabilities, we find it

¹³⁰ Exh. 2A:404 at 5-10 (Audit Report).

¹³¹ This discussion refers to issues referenced as index 29 in Appendices A, B, C and D.

¹³² Exh. 2A:404 at 7-34, table 7-12 (Audit Report).

¹³³ *In the Matters of Responsible Accounting Officer Letter 20, Uniform Accounting for Postretirement Benefits Other Than Pensions in Part 32, et al.*, AAD 92-65, CC Docket No. 96-22, FCC 97-56 (rel. Feb. 20, 1997) (FCC Order 97-56), ¶ 19.

appropriate to follow the FCC's guidance and exclude the liabilities from rate base.

Our approach achieves a reasonable result and we conclude that FAS 112 liability is inappropriate for inclusion in rate base.¹³⁴ Pacific's rate base is overstated by \$213.2 million in 1997, \$236.5 million in 1998, and \$255.4 million in 1999 as shown in Appendix A.

d) Accrued Vacation Pay Liability

Overland recommends that carry-over vacation pay – vacation pay accrued by employees in prior years – be deducted from rate base.¹³⁵ In accordance with the discussion in the previous section, we agree with the audit recommendation, because vacation pay liability, like FAS 112 liability, represents cost-free capital to the company. Thus, like FAS 112 liability, accrued vacation pay liability should not form part of the rate base on which Pacific is entitled to a return. Therefore, we adopt Overland's rate base adjustment of \$51.9 million in 1997, \$51.4 million in 1998, and \$45.7 million in 1999.

e) Accrued FAS 106 Liability

Overland seeks to remove Pacific's FAS 106 liability accruals from the balance sheet, which would reduce rate base by the amount on the balance sheet.¹³⁶ We agree that the liability should be excluded from rate base.

The Phase 2A decision also finds that ratepayers were not liable in 1999 and subsequent years for FAS 106 costs that Pacific chose not to fund. These unfunded accruals should be removed from rate base.

¹³⁴ See Exh. 2A:404 at 11-30 (Audit Report); FCC Order 97-56, ¶ 19.

¹³⁵ Exh. 2A:404 at 11-31 (Audit Report). This discussion refers to issues referenced as index 30 in Appendices A, B, C and D.

¹³⁶ This discussion refers to issues referenced as index 31 in Appendices A, B, C and D.

In addition, we note that the FCC has determined that FAS 106 liability should be removed from interstate rate base.¹³⁷ While the FCC's accounting approach is not controlling here, we often look to the FCC for guidance. Since there is no Commission authority that is inconsistent with the FCC approach, it is appropriate to follow the FCC approach in this instance. Pacific's rate base is misstated by \$124,000 for 1997, -\$6.0 million in 1998, and \$5.4 million in 1999 as shown in Appendix A.

f) Accrued Contingent Liabilities

Finally, Overland recommends that contingent liabilities be excluded from rate base.¹³⁸ We agree with Overland's recommendation in this instance, because we have disallowed as unauditable Pacific's contingent liability accruals, and required Pacific to account for its contingent liabilities on an as-paid basis. *See* Section entitled "Contingent Liabilities," above. Because we disallow accruals of these liabilities, there is nothing to add to rate base. Further, as is the case with several of the other items, contingent liabilities are cost-free sources of funds, and should not be included in rate base that is used to determine Pacific's rate of return and sharable earnings. Therefore, we adopt Overland's recommended rate base adjustments of \$28.0 million in 1997, \$20.1 million in 1998, and \$7.8 million in 1999.

¹³⁷ FCC Order 97-56 ¶ 19.

¹³⁸ Exh. 2A:404 at 11-34 (Audit Report). This discussion refers to issues referenced as index 32 in Appendices A, B, C and D.

H. Affiliate Transactions

1. Introduction

The audit did not conclude that internal control weaknesses affecting affiliate service transactions had a material impact on Pacific's CPUC financial results during the years 1997 through 1999. The audit found problems with the internal controls necessary to ensure that when Pacific transacts business with SBC affiliates, regulated operations are adequately compensated and do not subsidize unregulated aspects of the business.

The audit recommends adjustments during the audit period that increase Pacific's net income by \$97 million during the audit period.¹³⁹ In addition, ORA recommends continued audits of Pacific's affiliate transactions on the ground that Pacific hindered the auditors' initial efforts.

After addressing the undisputed affiliate transactions issues, we discuss the alleged deficiencies in Pacific's affiliate transactions practices. For reasons discussed below (Audit Discovery Disputes), we do not find that Pacific impeded the audit. We also find that a continued audit of affiliate transactions is not warranted.

2. Undisputed Affiliate Transactions Adjustments

Pacific conceded 13 of Overland's affiliate transaction-related adjustments, and we thereby adopt them.¹⁴⁰ Moreover, in light of the audit findings, Pacific acknowledges that it should improve some existing internal controls, related to

¹³⁹ *Id.*

¹⁴⁰ *See* Exhs. 2B:362A (revised chart, "Affiliate Transactions-Overland," listing disputed and "nondisputed" issues) and 2B:344 at 6-7 (Henrichs Direct Testimony).

classification of costs among its FCC Part 32¹⁴¹ accounts; retention of certain data to support allocations to Pacific; and revision to certain portions of the SBC Operations cost apportionment methodology.¹⁴²

Pacific states that it has already made several “enhancements” in response to the audit report. It has expanded its internal Advisory Oversight Group (AOG) staff; notified its responsible controller organizations regarding proper expense classification of shared services costs billed to Pacific; had AOG review its external affairs and lobbying costs; and refined its determination of cost causative factors for certain cost pools in SBC Operations.¹⁴³ We next turn to a discussion of disputed issues.

3. Disputed Affiliate Transactions Adjustments

The auditors based their conclusions on a large number of issues, related to internal accounting controls; Pacific’s management control over actions of its parent and affiliate organizations; compliance with affiliate transaction requirements; transfer or use of customer information, trademarks and other intangible assets; and treatment of the costs of developing Advanced Services, Inc. (ASI), Pacific’s digital subscriber line (DSL) affiliate. We discuss each of these in turn.

¹⁴¹ 47 C.F.R. § 32 *et seq.* (FCC’s Part 32 Uniform System of Accounts, as adopted in relevant part by this Commission in D.87-12-063, 1987 Cal. PUC LEXIS 412).

¹⁴² Exh. 2B:344 at 9 (Henrichs Direct Testimony).

¹⁴³ *Id.*

a) Internal Accounting Controls

Overland's review of internal accounting controls resulted in the following conclusion:

We did *not* conclude that internal control weaknesses affecting affiliate service transactions had a *material* impact on Pacific's CPUC-basis financial results during the years 1997 through 1999.¹⁴⁴

The audit found weaknesses in Pacific's internal controls in the area of affiliate transactions. The audit report contains the following findings:

- Certain affiliates have allocation processes Overland could not effectively audit.
- Pacific's customer data system and possibly other operational support systems continue to be used by affiliates without compensation to Pacific Bell, even though SBC charges Pacific \$400 million annually for the use of its name.

Pacific claimed in response that Overland is speculating, and that "neither ORA nor Overland presented one shred of evidence that Pacific is not compensated for use of the customer database in violation of any affiliate transaction rules or regulations."¹⁴⁵ However, as we discuss in the Section entitled "Transfer or Use of Customer Information, Trademarks and Other Intangible Assets," below, the witness Pacific offered on this subject could not state whether or not SBC Operations made use of Pacific's customer data once it completed work on a Pacific-specific project.

¹⁴⁴ Audit Report, p. 12-3 (emphasis added); 10 TR 1004:16-19.

- Pacific Bell's transfer price calculations appear to be seriously flawed and lack cost support.

In response, Pacific claimed it gave Overland adequate information and that "Overland's alleged difficulty in auditing this area speaks, once again, to its lack of qualifications as an auditor. . . ." ¹⁴⁶ However, one of the items Pacific gave to Overland – "fair market value studies supporting Pacific's transfer prices" – was inadequate to show the prices were fair, as we discuss in the Section entitled "Compliance With Affiliate Transaction Requirements," below. We cannot determine whether the other information Pacific furnished – "fully distributed cost studies" and "general ledger detail" – was inadequate for Overland to determine how Pacific made its transfer price calculations. ¹⁴⁷

- Neither Pacific Bell nor SBC could supply information accurately depicting the affiliate organization as it was constructed for inter-company accounting and billing purposes.

In response, Pacific claimed that, "the type of organizational chart Overland desires serves no business function and is burdensome to maintain." ¹⁴⁸ This response is so dismissive of Overland as to raise a concern that Pacific was being willfully unhelpful to Overland's efforts. All it appears Overland was trying to do was to trace how Pacific's organizational structure functioned. Pacific provided Overland a list of "Responsibility Codes in its CENET database"

¹⁴⁵ Pacific Reply/Audit at 59.

¹⁴⁶ *Id.* at 60.

¹⁴⁷ *Id.*

¹⁴⁸ *Id.* at 61.

and urged Overland to figure out who did what from a large personnel database of “a company like SBC that employs nearly 200,000 individuals.”¹⁴⁹

- There is a lack of documentary support for corporate legal department charges to Pacific Bell.
- Subject matter experts designated to answer questions on behalf of SBC Services were unable adequately to define the organization’s boundaries or assure the auditors that anyone at SBC had a complete understanding of what SBC Services billed to affiliates in 1998 or 1999. In many respects, SBC Services was a tangle of accounting methods and affiliate billings that could not be effectively defined or audited.¹⁵⁰

We are concerned with certain aspects of the organization of SBC’s centralized functions. Pacific concedes this point, at least in part: “During the audit period, shared functions migrated from subsidiaries, including Pacific, to SBC Services. *Based on this migration, at least initially, the operations of SBC Services may have been difficult to analyze.*”¹⁵¹ Pacific then makes the oft-repeated assertion that “information was provided to Overland that was sufficient to analyze the migration to a proprietary chart of accounts.”¹⁵²

Affiliate transactions are one of the more difficult areas of regulatory accounting to understand. It may well be that when Pacific staff that works with affiliate transactions day in and day out attempt to explain Pacific’s methods to

¹⁴⁹ *Id.*

¹⁵⁰ *See* ORA Opening/Audit at 43-44.

¹⁵¹ Pacific Opening/Audit at 136 (emphasis added).

¹⁵² *Id.*

outsiders - regardless of their accounting expertise - the explanations are not clear. Since Overland did not conclude that the existing internal controls had led to a material impact on Pacific's CPUC-based financial results during the years 1997-1999 and because of the inherent complexity of this issue, we find no basis for further investigation into this matter. We invite proposals in future NRF proceedings addressing proposed changes in internal controls.

We now turn to Overland's specific recommendations on Pacific's affiliate transactions.

b) Compliance With Time Reporting Document Retention Requirements

Pursuant to a 1997 Consent Decree, the FCC required employees of certain SBC parent organizations to keep time records for affiliate transactions purposes.¹⁵³ Overland found Pacific to be out of compliance with this requirement and concluded that there were significant weaknesses in Pacific's internal controls related to affiliate transactions during the audit period.

At the threshold, there is a disagreement over which entities were required to keep the records. Overland opines that the Consent Decree applied to the SBC holding company as well as SBC Operations and SBC Services; Pacific claims the Consent Decree by its terms only binds SBC Communications Inc., the holding company, and is silent as to the other two entities.

The evidence supports Pacific's interpretation. The plain language of the Consent Decree clearly states which affiliates are included and obligated by its requirements. Neither SBC Services nor SBC Operations is included in the

¹⁵³ Exh. 2B:363 (FCC Consent Decree 97-9, AAD No. 95-32, Feb. 7, 1997).

Consent Decree. SBC Services and SBC Operations voluntarily adopted the time reporting requirements and have maintained those records only for consistency with the Parent. Accordingly, we need not address whether these entities actually complied.

(1) 1998 Affiliate Oversight Group (AOG) Compliance Review of SBC Operations

Overland claims that Pacific's own 1998 internal review of its affiliate transaction compliance made findings such as "SBC-OPS is not in compliance at this time," "A 70% rate of response and only 85% of employees . . . must be remedied," and "payroll data is unreliable."¹⁵⁴ Pacific contends these findings were in the draft report and that the final report stated that "SBC-Ops at year end true up will be in compliance. . . ." As previously discussed, we find that SBC Operations is not obligated by the Consent Decree to maintain time reporting document. We also find the final report more credible.

(2) SBC Operations "Image Maker" Program

Overland believes that Pacific's "Image Maker" program also provides evidence of inadequate internal controls at Pacific. At hearing, Pacific was able to refute Overland's concerns in this area.

Overland found evidence that it believed showed that the Image Maker program, an advertising campaign intended to create a standardized advertising image of SBC's affiliates in various phone directories, allowed SBC to preview directory ads before they ran and ensure better ad placement and size than third

¹⁵⁴ Exh. 2A:404 at 15-3 (Audit Report).

party companies. The evidence was an email message in which an SBC employee described Image Maker as “the strategy the Corp . . . has initiated to get all the SBC subsidiaries equal or better advertising with their competitors in every directory in the eight state territory.”

Pacific submitted four declarations¹⁵⁵ conclusively refuting the contents of the email message, and establishing that the Image Maker program made recommendations only after directories were published. Thus, for example, if in a published directory Pacific’s advertisements were not as prominent as those of a competitor, the Image Maker program highlighted this point and suggested modification of the ad in future directories. Because the program was based on analysis of already-published directories, we find no wrongdoing in the program or lack of internal control in its existence. We therefore reject Overland’s recommendation in this regard.

(3) Centralized Tracking for Legal Matters

Overland expresses concern about SBC’s current process for tracking legal matters, stating the process is unauditable and suggesting that Pacific create a centralized database to track costs and assist in budgeting and control. Pacific claims it already has such tracking within the legal department, and that adding other requirements to this process would only increase legal department expense which is allocated in part to Pacific. Pacific also claims that SBC has a procedure

¹⁵⁵ Exh. 2B:630.

in place to allocate legal costs in accordance with the requirements of FCC
Part 64.¹⁵⁶

¹⁵⁶ 47 C.F.R. § 64 *et seq.* Pacific Opening/Audit at 126.

There are substantial differences between Overland's opinion and Pacific's statements. The record does not establish that deficiencies exist in Pacific's tracking of legal matters, and we cannot determine whether change is appropriate. We invite proposals in future proceedings addressing changes in Pacific's tracking of legal matters.

c) Affiliate Issues: Management Fees and Research Assessment

(1) Alleged Excessive Management Fees

ORA and the audit both raised concerns that Pacific's parent entity and shared services affiliates load excessive "management fees" onto Pacific's regulated operations. Overland concluded that Pacific had no decision-making role in the quantity, type or price of these services. It noted that there was no documented dispute between Pacific and the entities charging Pacific such fees, which led to the conclusion that Pacific simply was not disputing those charges.

ORA concurred that the management fees raise concerns. It pointed out that, at the very least, the 30-fold increase in charges SBC Services passed on to Pacific over time – from \$30 million in 1999 to \$1.1 billion in 2000 – casts doubt on Pacific's assertion that its affiliates adhere to cost controls to ensure that all SBC companies receive the lowest cost service.¹⁵⁷

Pacific noted that it has no control over the pricing of these services, nor does the Parent or the other affiliates. The FCC and the Commission rules for affiliate transactions govern these costs. Pacific does, however, have the ability

¹⁵⁷ ORA Reply/Audit at 37.

to dispute the level or nature of the bills it receives for these costs. Pacific claims that the regulated entity does have a say in how much it pays SBC for services, even if it does not keep detailed written records. Pacific's witness testified as to "informal process" for resolving disputes done by telephone along with journal entries for corrections.¹⁵⁸

We find that Pacific's management had appropriate recourse concerning SBC decisions on the type and amount of management fees to assess on the regulated utility. We discuss the specific findings in more detail below.

(2) Corporate Charges for Research

Technology Resources Inc. (TRI) is responsible for research and development (R&D) for SBC and its affiliates. Overland expressed concern that it could not determine whether TRI's billings to Pacific were appropriate.¹⁵⁹ Pacific's only attempted justification was that Pacific was not qualified to question TRI's billings: "as the technology expert it is in the best interest of the affiliate to give TRI the ultimate decision with regard to project pursuit. As such, Pacific is not in the position to make the sort of determinations Overland suggests it should."¹⁶⁰ We agree with Pacific. Investment in technology and research always remains difficult to assess, yet it is this investment that has been the driving force in increasing the profitability and productivity of all modern

¹⁵⁸ 12 TR 1907:22-28; 1908:1-4, 18-28; 1909:1; 1911:12-1191:23; 1911:26-1912:22.

¹⁵⁹ This discussion refers to issues referenced as line 21 of Appendix A.

¹⁶⁰ Pacific Opening/Audit at 130.

firms. This small expense item does not deserve further scrutiny. We reject Overland's recommendation for TRI research expenses as unreasonable.

**d) Compliance With Affiliate
Transaction Requirements**

(1) Overview of Issues

Again, Pacific notes that Overland "did not conclude that internal control weaknesses affecting affiliate service transactions had a material impact on Pacific's CPUC-based financial results during the years 1997 through 1999."¹⁶¹

Pacific explained SBC's process of passing its costs on to affiliates, which relies on FCC Part 64 guidelines to establish the hierarchy of cost allocation. The first principle of such assignment is that "costs shall be directly assigned to either regulated or nonregulated activities whenever possible."¹⁶² Overland found that most of SBC's allocations were based not on this first principle requiring direct assignment, but rather were based on a general allocator based on the size of the affiliate's investment. Since the regulated telephone companies have the greatest amount of investment, they bear a large portion of costs.

Part 64 only allows reliance on a general allocator after all other, more specific, methods of allocation have been tried:

(b) In assigning or allocating costs to regulated and unregulated activities, carriers shall follow the principles described herein:

...

¹⁶¹ Pacific Opening/Audit at 130, citing Exh. 2A:404 at 12-3 (Audit Report).

¹⁶² 47 C.F.R. § 64.901(b)(2).

(2) Costs shall be directly assigned to either regulated or nonregulated activities whenever possible.

(3) Costs which cannot be directly assigned . . . will be described as common costs Each cost category shall be allocated between regulated and nonregulated activities in accordance with the following hierarchy:

(i) Whenever possible, common cost categories are to be allocated based on direct analysis of the origin of costs themselves.

(ii) When direct analysis is not possible, common cost categories shall be allocated based upon an indirect, cost-causative linkage to another cost category (or group of categories) for which a direct assignment or allocation is available.

(iii) *When neither direct nor indirect measures of cost allocation can be found, the cost category shall be allocated based upon a general allocator computed by using the ration of all expenses directly assigned or attributed to regulated and nonregulated activities.*¹⁶³

Pacific makes the claim that it follows the Part 64 methodology.

We next review Overland's findings and the evidence in the record to resolve each issue identified by Overland.

(2) Booking of Parent Costs

Pacific acknowledges that it "inadvertently classified certain expenses to the incorrect Part 32 accounts" and "has implemented a number of enhancements to ensure appropriate Part 32 classification of costs." IEMR earnings were not impacted because the misallocations were appropriately

¹⁶³ *Id.* § 64.901 (emphasis added).

designated as above- or below-the-line.¹⁶⁴ In addition, Pacific has implemented a number of enhancements to ensure appropriate Part 32 classifications of costs in the future.

(3) Booking of Costs for Shared Services Affiliates

Overland states that SBC Operations did not retain certain documents supporting the SBC Operations allocation factors. Pacific concedes that “in certain areas documentation was inadvertently lost.” It states that AOG, its internal auditing group, has expanded its role to include oversight of SBC’s shared service organizations’ cost allocation systems, allocation methodologies and document retention, and that AOG centralized the document retention function.

Overland acknowledges that costs allocated from SBC Operations to Pacific did not have a material impact on Pacific’s financial results. Moreover, the AOG has expanded its role to include oversight of SBC’s shared service organizations’ cost allocation systems, allocation methodologies and document retention. A comprehensive review was performed and document retention enhanced. There is no need for further Commission action.

(4) Services Provided by Pacific Bell to Affiliates

It was Overland’s opinion that SBC was not able to provide an audit trail demonstrating that its system of billing affiliates for services Pacific provided to

¹⁶⁴ Pacific Opening/Audit at 132.

SBC unregulated affiliates was functioning properly.¹⁶⁵ Overland then went on to make the following observation:

We believe controls functioned as intended from the point at which affiliate units were input into the affiliate billing system. . . These generally functioned to provide the intercompany balance control as intended.¹⁶⁶

We find that this observation supports the general conclusion that proper internal controls are functioning as intended for Pacific's billing system and collection of affiliate costs. Overland also found that there were discrepancies between costs Pacific tracked for marketing services performed on behalf of affiliates and the amount Pacific billed the affiliates for these services.¹⁶⁷

Overland then expressed concern that Pacific was not charging its affiliates a 10% mark-up as required in D.86-01-026. Pacific claims such markup is not required for its transactions with *regulated* affiliates due to an FCC order that "Transactions between two regulated affiliates do not present the same potential for cost shifting and need not adhere to these [affiliate] rules."¹⁶⁸ Pacific claims it does impose the 10% mark-up on its nonregulated affiliates. Pacific explains that application of the 10% mark-up for billings to regulated affiliates creates the potential for cross-subsidization, which is at odds with the fundamental basis for affiliate rules.

¹⁶⁵ Exh. 2A:404 at 17-1 (Audit Report).

¹⁶⁶ Audit Report, p. 17-8.

¹⁶⁷ Exh. 2A:404 at 20-37 – 20-38 (Audit Report).

Overland is also concerned that Pacific has not justified the rates it charges affiliates under the requirement that it charge the higher of fair market value (FMV) or fully distributed cost (FDC). Pacific claims it uses a market research firm to survey and provide the FMV of third party services. Pacific states this method of determining FMV is consistent with the FCC's Accounting Standards Order, in which the FCC "set a baseline for a good faith determination of fair market value by requiring carriers to use methods that are routinely used by the general business community."¹⁶⁹

Pacific's practice of using a market research firm to survey and provide FMV of third party services meets the FCC requirement stated above. We agree with Pacific that market studies prepared by a third party consultant provide a reasonable proxy for market value. Overland's assertion that market comparisons should be made on a whole function basis is unnecessary and exceeds regulatory requirements.

e) Other Compliance Issues Concerning Affiliate Transaction Rules - AMDOCS

Overland found that Pacific Bell Directory did not follow Commission rules requiring purchases from AMDOCS – an SBC software subsidiary – to be recorded at the lower of FDC or FMV. Pacific does not disagree, claiming it "inadvertently did not apply the appropriate affiliate rules." Overland also found that the negotiated prices did not have a material impact on Pacific Bell

¹⁶⁸ FCC *Order on Reconsideration*, FCC 87-305, ¶ 122.

¹⁶⁹ FCC *Accounting Standards Order*, CC 96-150, ¶ 154.

Directory's contribution to regulated operating income.¹⁷⁰ Since this issue had no material impact, we reach no finding on this matter.

**f) Transfer or Use of Customer Information,
Trademarks and Other Intangible Assets**

Overland found that “electronic access to Pacific Bell’s customer database was effectively transferred to SBC Operations during the audit period” and that “Pacific Bell has not been compensated for the transfer.” TURN concurs.

Pacific did not dispute that it allows SBC Operations to use its customer database for the purpose of marketing Pacific Bell’s services. However, Pacific claimed that it simply gave Shared Services “access” to the database, and denied that there was a “transfer” of customer records. TURN asserts that the record actually supports the conclusion that there was a “transfer” of data.

Pacific categorically denies that its affiliates make any use of Pacific’s customer information except to conduct marketing for Pacific’s own benefit. Pacific adds that it is compensated when required in accordance with existing FCC and Commission affiliate transaction rules. Overland states that time and scope constraints prevented it from assessing the potential for cross-subsidies relating to the transfer of intellectual property and proprietary information.

Customer database usage is a viable component of SBC Operations marketing services fully distributed labor cost. We find that the policies and procedures, where SBC Operations markets on behalf of affiliates, are consistent with D.87-12-067, which provides a 13% sales fee for the revenues associated with

¹⁷⁰ Henrich’s Corrected Direct Testimony, Exh. Pacific:Phase 2B:344, p. 77.

customer data usage. The “access” that Overland refers to is proper, as it is access provided to SBC Operations on Pacific’s behalf. Where joint marketing occurs, the access is still on Pacific’s initiative with appropriate fees paid when required. We do not find that SBC Operations has provided use of Pacific’s customer database to any other affiliate. Overland has provided no evidence to the contrary.

g) Transfer of Pacific Bell Directory to Pacific Telesis Group

Overland reports that Pacific Bell did not obtain the Commission’s permission to transfer Pacific Bell Directory to its then-parent, Pacific Telesis Group. Overland, however, did not attempt to draw a conclusion, legal or otherwise, about whether the transfer was permitted. Overland notes that Pacific did inform Commission staff in writing of the determination that Commission approval was not required to effect the transfer.

On the specific question of whether § 851 *et seq.* approval was required in these circumstances, we find that it was required. A specific resolution addressed the transfer, and in it the Commission stated: “It is appropriate for the Commission to evaluate the transfer of [Pacific Bell Directory] to Pacific Telesis. Therefore, the Commission will consider ORA’s recommendation to review this transaction, and if an investigation is deemed appropriate, the Commission will open a proceeding to review this transaction.”¹⁷¹

¹⁷¹ Resolution T-16545, *Order Adopting Modifications to the Reporting Requirements Under NRF Monitoring Program*, dated August 23, 2001, at 15.

The Commission, however, neither deemed an investigation appropriate nor opened a proceeding to review this transaction. On the other hand, the Commission never granted Pacific authority to make the transfer. There is thus a question as to whether a transfer of Pacific Bell Directory would require Commission approval.

In D.85-12-065,¹⁷² the Commission granted Pacific approval to transfer its directory properties to a separate subsidiary of Pacific Bell, ostensibly to allow Pacific to respond to developing competition in the classified directory business and in other print media businesses. However, in approving the transfer, provided that “Pacific Bell Directory shall be subject to all applicable sections of the Pub. Util. Code and of General Order 77-I, but not to the Uniform System of Accounts generally applicable to telephone utilities under Commission jurisdiction.”¹⁷³ Thus, the Commission did not exempt Directory from compliance with Sections 851 *et seq.*, if it should apply. The Commission also required the consideration of the revenues and expenses of the Directory operation in setting Pacific Bell’s rates.

Article 6 of the Pub. Util. Code (Sections 851-56) addresses the transfer or encumbrance of utility property. For example, § 851 prohibits a public utility from selling, leasing, assigning, mortgaging, or otherwise disposing of or encumbering the whole or any part of its system or other property necessary or useful in the performance of its duties to the public. It is unclear whether Section

¹⁷² 1985 Cal. PUC LEXIS 1063.

¹⁷³ Resolution T-16545, *supra*, ordering paragraph 6.

851 applies to the transaction – although the revenues and costs associated with Directory operations were considered in setting Pacific’s rates, the operation were longer part of the core utility business.

It is also unclear whether the shift of the subsidiary from Pacific Bell to Pacific Telesis, the overall parent, constitutes a change in control as defined in Article 6. Nevertheless, when such a transfer of an asset raises legal issues such as these, the common procedure for resolving these issues is for the applicant to file an application seeking Commission approval or a determination that the transaction does not require Commission approval.

Therefore, Pacific Bell shall file an application to seek a Commission determination whether Article 6 of the Pub. Util. Code applies to this transaction and seeking Commission approval in the event that the Commission finds that Article 6 applies. Pacific should file an application for the transfer no later than 60 days following the effective date of this decision. This filing shall also comply with all of the requirements of D.85-12-065.

h) Advanced Services, Inc.

Overland opines that Pacific’s intrastate ratepayers should be compensated for the development of the digital subscriber line service (DSL), service and the transfer of tangible and intangible assets to Pacific’s affiliate, Advanced Services, Inc. (ASI). ASI is important because it is the entity in which most of Pacific’s DSL services are housed. There is currently a very active and growing market for DSL in Pacific’s territory.

Overland recommends that the Commission review the transactions and investments related to ASI and advanced services in general to determine whether Pacific Bell’s affiliate transactions and asset transfer accounting with ASI

are consistent with Commission rules. Pacific's witness agreed that this was an appropriate audit issue.¹⁷⁴

Overland found that during the audit period, Pacific expensed \$225 million in developing DSL and capitalized an additional \$261 million in DSL investment, but recorded just \$25 million in regulated revenues for DSL service. Overland concludes that Pacific's regulated customers provided over \$190 million in net funding for the development of DSL assets to ASI.

(1) Appropriateness of Considering ASI in this Proceeding

At the threshold, there was controversy over whether we should consider Pacific's behavior vis-à-vis ASI at all in this proceeding. Pacific noted that we have another open proceeding in which Pacific seeks approval pursuant to Pub. Util. Code § 851 to transfer assets from Pacific to ASI,¹⁷⁵ and urged us to consider all ASI issues there. We find that the current record lacks information that is necessary for us to rule on the issue of ratepayer compensation for DSL development costs. Therefore, we agree that it is appropriate to defer certain issues to the § 851 proceeding.

(2) Ratepayer Funding of DSL Development Costs

ORA and TURN claim the Commission should compensate ratepayers for bearing the risk of investment in DSL. In contrast, Pacific claims that ratepayers have not borne these expenses and therefore need not receive compensation.

¹⁷⁴ 12 RT 1285:3-8 (Hayes).

¹⁷⁵ Application 02-07-039.

Pacific claims that it never increased basic rates or any other non-DSL price in order to recover the development costs. “[O]ther than customers that specifically purchased advanced services, no costs were otherwise charged to customers and thus there is nothing to reimburse.”¹⁷⁶ Pacific also claims it charged DSL development costs to below-the-line accounts, consistent with Commission requirements for new product development as described in D.94-06-011. In 1998, it claims it received Commission Advice Letter approval in Resolution T-16191 to place the service above-the-line.

Overland states that prior to 1998, Pacific accounted for the services below-the-line, but that as development costs mounted, Pacific moved DSL expenses above-the-line to regulated services accounts, where they reduced regulated operating income in 1998 and 1999.¹⁷⁷ Overland found that during the audit period, Pacific incurred \$261 million in costs to develop DSL, but recorded revenues of just \$25 million: “[DSL] was transferred to ASI just as service deployment was being ramped up, but regulated customers were not reimbursed for the development they funded. As such, regulated customers subsidized more than \$190 million in DSL development benefiting unregulated affiliate ASI.”¹⁷⁸

¹⁷⁶ Pacific Opening/Audit at 156-57.

¹⁷⁷ Exh. 2A:404 at 19-3 (Audit Report).

¹⁷⁸ *Id.* While no longer obligated to do so, Pacific continues to maintain its advanced services business in a separate affiliate. When the FCC approved Pacific’s merger with Ameritech, it allowed SBC to choose whether to keep advanced services operations in ASI or to reintegrate them into the regulated utility subject to certain conditions. Pacific benefited from keeping the assets separate from the regulated telephone company

Footnote continued on next page

If California ratepayers did bear a risk and the costs associated with DSL development, then they should be compensated. The question is whether ratepayers did in fact bear risks and costs associated with DSL development, how much risk and cost they bore, and how California ratepayers should be compensated for the risk they bore associated with the cost of DSL's development.

because in so doing it could avoid the obligation to resell its DSL service to potential competitors pursuant to 47 U.S.C. § 251(c). However, in *Association of Communication Enterprises v. FCC*, 235 F.3d 662, 665 (D.C. Cir. 2001), the court decided that transferring advanced services assets into an unregulated affiliate did not get incumbent local exchange carriers out from under the resale obligation. Therefore, transferring ASI no longer accomplished that goal for Pacific. Nonetheless, for its own reasons, it continues to house ASI in an unregulated affiliate.

We lack a sufficient record here upon which to resolve the TURN and ORA claim for ratepayer compensation. We lack information about the “separation” of costs and revenues between the interstate and intrastate jurisdictions, which may be a relevant consideration in deciding the ratepayer compensation issue.¹⁷⁹ We also lack data about affiliate payments and other revenues that Pacific may receive from furnishing DSL-related services to ASI. Furthermore, it would be helpful to have expense, investment, and revenue information for the years 2000 and beyond, information we also lack here. We believe the ASI asset transfer proceeding would be a better docket in which to determine whether ratepayers are entitled to compensation, and therefore defer this issue to that docket.

In addition to DSL service, we are concerned that Pacific may have developed other services above-the-line and transferred them to ASI. We do not want to prejudge what regulatory treatment should be afforded these other services, if there are any. Nevertheless, Pacific should be able to identify each service transferred from Pacific to ASI and to track the revenues, expenses, and investment for each service.

¹⁷⁹ For instance, if DSL-related costs are treated as intrastate costs and revenues from the sale of DSL services are treated as interstate revenues, there would be a mismatch between costs and revenues, which could be relevant to our determination with respect to ratepayer compensation.

i) Affiliate Transactions Audit Adjustments

Overland proposes adjustments of \$11.5 million in 1997, \$38.5 million in 1998 and \$47.4 million in 1999 on an intrastate after-tax basis as a result of its affiliate transactions analysis based on the information provided thus far. We discuss its proposed adjustments in turn.

(1) Operating Revenue Adjustments – 1999 Employee Transfer Fee

Overland states that “Pacific Bell transferred 2,935 employees to SBC Services in December 1999, but did not accrue the \$47 million in associated transfer fee revenue” in that year. At hearing, Pacific established that it did book the fee, but did so on January 1, 2000 rather than on December 31, 1999. Overland conceded during the hearing that Pacific’s actions were appropriate, and we take no further actions on this matter.

(2) Operating Expense Adjustments for Executive Compensation¹⁸⁰

Overland states that compensation for SBC executives exceeded the regulated limit established by the Commission in D.86-01-026. Pacific claims that D.86-01-026, adopted under rate-of-return regulation, does not apply to utilities operating under NRF.

However, ORA points out that “[t]he Commission’s longstanding policies regarding excessive executive compensation, unreasonable legal expenditures, image building public relations costs, corporate mergers and acquisitions and the

¹⁸⁰ This discussion refers to issues referenced as index 46 and 56 in Appendices A, B, C and D.

parent company's strategic planning must not be ignored in the conduct (sic) of this first ever SBC Pacific NRF regulatory audit."¹⁸¹ Moreover, ORA points out, the Commission has made "ratemaking adjustments" even in the context of NRF.

We do not need to reach the issue ORA raises. With regard to executive compensation, Pacific agreed voluntarily to limit its regulated operations' exposure for Pacific Bell executive compensation to \$200,000 per year per executive. Its witness so testified:

Q. Did Pacific Bell make a ratemaking adjustment on the IEMR for executive compensation during the audit period?

A. Yes. Pacific voluntarily reduced intrastate regulated operating expense by \$20 million, \$8 million, and \$7 million in 1997, 1998 and 1999 respectively.¹⁸²

Nor should Pacific's regulated operations bear the expense of executive compensation over \$200,000 per year if the executives work for affiliates of Pacific Bell, rather than for Pacific Bell itself. At least as to the audit period, we find that SBC entities' executive compensation recorded for regulatory purposes should be capped at \$200,000 per year per executive in keeping with Pacific's voluntary "ratemaking adjustment," regardless of where those executives are employed.

Finally, for its excess executive compensation costs, the Commission's affiliate transaction rules require that there be some benefit associated with an allocated cost. Pacific showed no such benefit. Therefore, we adopt the

¹⁸¹ ORA Reply/Audit at 46.

¹⁸² Exh. 2B:338 at 61:7-11 (Ellis Direct Testimony).

intrastate regulatory after-tax amounts of \$1.5 million in 1997, \$6.8 million in 1998, and \$7.1 million in 1999 for the excess executive compensation from the parent company. We also adopt the intrastate regulatory after-tax amounts of \$2.0 million in 1999 for the excess executive compensation from MSI – USA as shown in Appendix A.

(3) Operating Expense Adjustment for Executive Award Payments Allocated to Pacific

SBC made award payments to certain of its key executives in connection with SBC's 1998 investment in AMDOCS, a telecommunications software company, and SBC's merger with Ameritech.¹⁸³ In turn, SBC allocated a portion of these payments to Pacific using a general allocator under Part 64. It is Overland's opinion that the payments were not attributable to Pacific Bell under cost causative principles.¹⁸⁴ We agree. We also find that Pacific's regulated operations should not have borne any of these executive award payments because they exceeded the \$200,000 threshold for executive pay we set forth in the previous section. The executive award payments for AMDOCS and Ameritech are embedded in the excess executive compensation from parent company.

¹⁸³ See Exh. 2A:404 at 14-3 (Audit Report).

¹⁸⁴ This discussion refers to additional issues embedded in the figures referenced as index 46 in Appendices A, B, C and D.

(4) Executive Compensation Allocated From Parent to Pacific Bell Directory

Similarly, Overland states that certain executive compensation awards payments should not have been allocated by the SBC parent organization to Pacific Bell Directory and were excessive.¹⁸⁵ We agree because compensation in the amount of \$200,000 exceeded the cap on ratepayer contribution to executive compensation to which Pacific voluntarily agreed, as explained above, and because Pacific failed to establish a causal connection between the compensation and Pacific's operations. The excess compensation allocated from parent to Pacific Bell Directory is embedded in "Parent Impact of Adjustments on Billings to PBD" (Joint Exhibit #55).

(5) Special Executive Compensation Allocated From Parent to Pacific Bell Directory¹⁸⁶

Pacific Bell Directory bore yet another executive compensation expense - called "special executive compensation" - based on a general allocator. Pacific contends that, "because the scope of responsibility of these key executives is to oversee the operations of SBC, the costs are appropriately allocated to the SBC family of companies, including Pacific Bell Directory."¹⁸⁷ Pacific fails to prove the linkage, and once again this compensation exceeds the executive compensation cap. Thus, we accept Overland's recommendation. The special

¹⁸⁵ Exh. 2A:404 at 14-3, 14-8 and 18-8 (Audit Report). This discussion refers to issues embedded in the figures referenced as index 55 in Appendices A, B, C and D.

¹⁸⁶ This discussion refers to additional issues embedded in the figures referenced as index 55 in Appendices A, B, C and D.

¹⁸⁷ Pacific Opening/Audit at 162.

executive compensation allocated from parent to pacific Bell Directory is embedded in “Parent Impact of Adjustments on Billings to PBD” (Joint Exhibit #55).

(6) Executive Compensation Allocated from SBC Operations

Pacific also bore the expense of the AMDOCS acquisition/Ameritech merger executive compensation allocated to it by SBC Operations (and not just the parent, as we discuss above). ¹⁸⁸ Once again, we disallow any executive compensation in this area in excess of \$200,000, for the reasons set forth above. In addition, Pacific failed to show that it appropriately bore this expense from a cost causative perspective. We therefore adopt Overland’s recommendation to disallow the expense. The intrastate regulatory after-tax amount for AMDOC Awards from SBC Operations is \$253,000 in 1999. The intrastate regulatory after-tax amounts for excess executive compensation from SBC operations are \$481,000 in 1998 and \$625,000 in 1999 as shown in Appendix A.

(7) Executive Compensation Allocated from SBC Services¹⁸⁹

Once again, Pacific bore executive compensation related to the AMDOCs acquisition/Ameritech merger – this time allocated to it by SBC Services. We again adopt the audit recommendation to disallow this expense, based both on the \$200,000 cap and on Pacific’s failure to show that it appropriately bore the

¹⁸⁸ This discussion refers to issues referenced as index 40 and 41 in Appendices A, B, C and D.

¹⁸⁹ This discussion refers to issues referenced as index 44 in Appendices A, B, C and D.

expense from a cost causation perspective. The intrastate regulatory after-tax executive compensation allocated from SBC services is \$163,000 in 1998 and \$135,000 in 1999 as shown in Appendix A.

j) Legal Expenses

(1) Legal Expenses Allocated from Parent to Pacific

Overland opines that SBC improperly allocated to Pacific legal fees associated with SBC's work on 1) Constitutional issues regarding the Telecommunications Act of 1996 (1996 Act), 2) Section 271 long distance service applications pursuant to the 1996 Act, and 3) Pacific's participation in the AT&T/Media One merger proceeding.¹⁹⁰

Pacific claims that each of the three matters "relate to SBC legal activities benefiting both regulated and non-regulated subsidiaries," but as TURN points out, Pacific nowhere explains that benefit or demonstrates that the expense directly applied to the utility's regulated activities. While Pacific lists several obligations that the 1996 Act imposes on the regulated utility, it never claims that its litigation of the constitutional issues and the Section 271 long distance application raised those issues. Thus, we agree with TURN that, "Pacific Bell has failed to demonstrate that these costs meet the utility's own standard."¹⁹¹

TURN further notes that "Pacific Bell did not even bother with the pretense of citing aspects of [the AT&T/Media One merger] that might have implications for its regulated operations." Because Pacific concedes that

¹⁹⁰ This discussion refers to issues referenced as index 48 in Appendices A, B, C and D.

¹⁹¹ TURN Reply/Audit at 35.

“[r]elevance and direct application to Pacific’s regulated operations guides whether or not these legal costs are attributable to Pacific,” and Pacific makes no such showing, we disallow the expenses and adopt Overland’s recommendation. The intrastate regulatory after-tax amounts are \$439,000 in 1998 and \$212,000 in 1999 as shown in Appendix A.

**(2) Legal Expenses Allocated From Parent to Pacific
Bell Directory**

Overland proposes an adjustment lowering Pacific’s operation costs for legal expenses it claims the parent misallocated to Pacific Bell Directory.¹⁹² Once again, Pacific simply asserts that the expenses meet the requirement that such costs be relevant and directly applicable to Pacific Bell Directory’s operations with no further evidence.

We adopt Overland’s audit recommendation on this issue, as Pacific has failed to demonstrate – as it is required to do – how the legal expenses the parent operation billed benefited Directory. The legal expenses allocated from parent to Pacific Bell Directory are embedded in “Parent Impact of Adjustments on Billings to PBD” (Joint Exhibit #55).

**k) Public Relations and Corporate
Sponsorship Allocated from Parent to Pacific
and Pacific Bell Directory**

Pacific disputes Overland’s audit adjustments related to parent expenses for public relations and corporate sponsorship allocated to Pacific Bell and

¹⁹² This discussion refers to additional issues embedded in the figures referenced as index 55 in Appendices A, B, C and D.

Pacific Bell Directory, because Pacific maintains that NRF does not allow “ratemaking adjustments.”¹⁹³ However, the issue is not whether a ratemaking adjustment is proper, but whether Pacific Bell and Pacific Bell Directory are improperly cross-subsidizing the parent’s activities. Such cross-subsidies are anticompetitive, because they allow the parent to operate on more favorable terms than comparable businesses outside SBC, which do not have a regulated utility to rely on to subsidize their unregulated operations.

Pacific did not dispute the auditor’s non-affiliate-transaction adjustments in connection with similar items.¹⁹⁴ If Pacific’s regulated operations should not bear the cost of image advertising, as Pacific concedes, then it follows that Pacific should not bear the cost of such advertising carried out by an unregulated parent or affiliate of Pacific, as occurred here.

The public relations and corporate sponsorship expense from parent company amounts is \$1.7 million in 1997, \$8.6 million in 1998, and \$8.8 million in 1999 on an intrastate regulatory after-tax basis as shown in Appendix A. The piece from Pacific Bell Directory is embedded in “Parent Impact of Adjustments on Billings to PBD” (Joint Exhibit #55).

¹⁹³ This discussion refers to issues referenced as index 49 in Appendices A, B, C and D.

¹⁹⁴ See table of “Undisputed Audit Adjustments” in Appendix D to this decision, showing Pacific’s agreement to similar adjustments related to parent political and legislative influence expense, and parent contributions, memberships and foundation expense. See also D.94-06-011, 153 PUR 4th 65 (1994), 1994 Cal. PUC LEXIS 456, at *116 (noting that Pacific records and should continue to record dues, donations and political advocacy expenses below-the-line).

I) Corporate Development Costs¹⁹⁵

Pacific was charged in 1998 and 1999 when an unregulated affiliate, MSI, conducted market research and investigated potential acquisitions throughout the world. Once again, Pacific claims without evidence that the costs were appropriately allocated from the parent to Pacific and Pacific Bell Directory, and once again we reject Pacific's claim and adopt Overland's audit recommendation.

These expenses relate to international lines of business,¹⁹⁶ and we see no relationship between such investments and the regulated utility. Pacific's argument that these corporate acquisitions somehow benefit Pacific "by lowering Parent allocations to Pacific as the portfolio of SBC companies grow" is entirely circular.¹⁹⁷ If the allocation does not otherwise benefit Pacific, such benefit does not occur simply because in the future Pacific's share of the allocation will lessen as SBC grows bigger. Thus, we adopt Overland's recommendation of \$3.1 million in 1998 and \$3.5 million in 1999 on an intrastate after-tax basis from parent company as shown in Appendix A. The piece from Pacific Bell Directory is embedded in "Parent Impact of Adjustments on Billings to TBD" (Joint Exhibit #55),.

¹⁹⁵ This discussion refers to issues referenced as index 50 in Appendices A, B, C and D.

¹⁹⁶ *See* Exh. 2A:414 at 14-34 (Audit Report) (listing corporate development projects around the world).

¹⁹⁷ Pacific Opening/Audit at 167, citing Exh. 2B:344 at 27 (Henrichs testimony).

m) Strategic Planning Costs¹⁹⁸

Pacific's only argument against Overland's questioning of the SBC parent's allocation of "strategic planning" expenses to Pacific and Pacific Bell Directory is that NRF countenances no ratemaking adjustments. The issue here is whether Pacific and Pacific Bell Directory are cross-subsidizing the parent's strategic planning activities, which benefits the parent at the expense of competing telecommunications companies.

Pacific nowhere explains how the strategic planning activities benefit the regulated utility, and without such justification, it is improper for the utility to subsidize them. We therefore adopt Overland's recommendation of \$1.7 million in 1997, \$532,000 in 1998, and \$410,000 in 1999 for the strategic planning expenses from the parent company on an intrastate after-tax basis as shown in Appendix A. The piece from Pacific Bell Directory is embedded in "Parent Impact of Adjustments on Billings to PBD" (Joint Exhibit #55).

n) Parent Out of Period Expense¹⁹⁹

The parent company billed Pacific \$7.4 million in 1998 for services rendered in 1997. Overland states they should have been billed in 1997, but Pacific claims the true amount of the services was not known or billed until 1998. Because Pacific's only basis for argument is that GAAP does not allow us to "reopen a closed accounting period," and we have already rejected that

¹⁹⁸ This discussion refers to issues referenced as index 51 in Appendices A, B, C and D.

¹⁹⁹ This discussion refers to issues referenced as index 53 in Appendices A, B, C and D.

argument elsewhere, we adopt Overland's recommendation of -\$3.4 million in 1997 and \$3.4 million in 1998 on an intrastate after-tax basis.

o) Regulated and Nonregulated Cost Allocations

Overland proposes a number of adjustments which are discussed below. However, Overland's ultimate conclusion is that "Pacific's procedures for regulated and nonregulated activities were well controlled and consistent with Commission requirements and FCC Part 64 attributable cost principles."²⁰⁰

(1) Marketing Service – Affiliate Billings²⁰¹

A significant issue arose at the hearings as to whether Pacific's affiliates fully compensate the regulated business when Pacific performs marketing functions for them. In finding a mismatch between revenues and expenses (with revenues to Pacific much lower than its expenses), Pacific maintained that ORA was comparing apples to oranges.

We find that Pacific did properly record the inter-company revenue associated with marketing services provided to affiliates. We agree with Pacific that ORA and Overland's findings are based on incorrect comparison of the results of two separate and distinct processes: 1) the CASS process which determines expenses associated with market services; and 2) the affiliate billing process which determines the revenue associated with marketing services. Because the adjustment is based on an improper comparison, we reject the recommended adjustment.

²⁰⁰ Audit Report, p. 20-1.

²⁰¹ This discussion refers to issues referenced as index 63 in Appendices A, B, C and D.

**(2) Allocation of National-Local Strategy
Implementation Costs²⁰²**

Overland states that Information Technology (IT) costs associated with Pacific's effort to expand service into 30 metropolitan areas outside of Pacific's service area should be charged to SBC National-Local, its competitive local exchange affiliate, and not to the regulated telephone company. According to Overland, Pacific Bell caused regulated California operating expense to be overstated by \$7.9 million in 1999 on a regulated basis.

Pacific maintains that Overland misunderstood its data. It claims the data provided contained all IT costs related to the project no matter who performed the work. It states that Pacific employees recorded only 3.5% of the total IT hours worked, and that Pacific has already billed SBC National-Local for the work performed. Therefore, Pacific claims, its regulated operations did not subsidize work Pacific performed on behalf of Pacific's National-Local affiliate.

Pacific's claim is inconsistent with the evidence in the record. Contrary to Pacific's statement in its brief that Overland misunderstood its data, Pacific in discovery claimed the allocation was proper because Pacific's effort to expand into metropolitan areas outside Pacific's service territory "was thought to benefit the company as a whole rather than a specific regulated or nonregulated area. Therefore, residual allocation was chosen as the method to allocate these costs."²⁰³

²⁰² This discussion refers to issues referenced as index 65 in Appendices A, B, C and D.

²⁰³ Exh. 2A:404 at 20-49 n.54 (Audit Report), citing Pacific Bell Data Response OC-1040 part 3.

Pacific would not have had to make this claim if, as it asserts, it was not billing Pacific for the work. We fail to see how these expenses benefited the regulated utility and adopt Overland's audit recommendation. Any cross-subsidy flowing from Pacific's regulated operations to its National-Local competitive local exchange affiliate would be anticompetitive, as unaffiliated competitive local exchange carriers receive no such subsidy.

Thus, we agree that Pacific's regulated operations should not have borne any expense related to Pacific's National-Local affiliate. Pacific shall remove \$3.7 million on an intrastate regulatory after-tax basis from its 1999 IEMR.

(3) 1997 Corporate Sponsorship Costs – Pacific Bell Park²⁰⁴

Overland states that in 1997 Pacific improperly recorded a portion of the payment it made for the naming rights to Pacific Bell Park above-the-line. Overland opines that Pacific may not record this type of "corporate image advertising" above-the-line pursuant to D.86-01-026, and that \$1,014,546 should be removed from operating expense for that year. In D.01-06-077, we stated that "[t]he Commission does not allow recovery from ratepayers of institutional or goodwill advertising."²⁰⁵

Pacific's only rebuttal is that D.91-07-056 "eliminated ratemaking adjustments." However, in D.01-06-077, we have already assessed this argument vis-à-vis institutional or goodwill advertising in the context of NRF and decided

²⁰⁴ This discussion refers to issues referenced as index 66 in Appendices A, B, C and D.

²⁰⁵ 2001 Cal. PUC LEXIS 604, at *44-45, citing D.83162 (1974), 77 CPUC 117, 154-55 & D.96-12-074, *mimeo.*, at 135-36.

that such a ratemaking adjustment is proper. Therefore, we agree with Overland that Pacific should not have recorded the expenses in the amount of \$1.0 million (on an intrastate after-tax basis) above-the-line.

(4) Depreciation Expense Allocation²⁰⁶

Overland next states that monthly depreciation recorded in 1999 was improperly distributed between regulated and non-regulated activities. Pacific then made correcting entries in December 1999 to correct errors in the prior 11 months, using the allocation ratio applicable in December 1999. Overland states that when Pacific corrected the error, it should have used allocation ratios applicable for each month in 1999 in which the errors occurred, rather than using only the December 1999 ratio. Because the ratio changed over those months, the result was an understatement of non-regulated depreciation expense.

Pacific alleges that it often makes correcting entries and that there is no precedent for allocating correcting entries differently than the regular monthly allocation process. It claims that to do what Overland suggests would violate the Cost Allocation Manual (CAM) that Pacific has filed:

There is no precedent for allocating correcting entries differently than the regular month allocation process. The Cost Allocation Manual (Section 6) describes the allocation process and does not allow the allocation process to be changed if significant correcting entry is performed in any one month.²⁰⁷

²⁰⁶ This discussion refers to issues referenced as index 60 in Appendices A, B, C and D.

²⁰⁷ Ellis Revised Direct Testimony, Exh. Pacific: Phase 2B:338, p 37-38.

We agree with Pacific's analysis. Pacific followed the existing Commission policy during the audit period when it allocated the December correcting entries using the December 1999 cost allocation ratios for depreciation expense. We therefore reject the audit recommendation.

(5) Product Advertising Expense²⁰⁸

Overland finds that Pacific's Product Advertising Expense was not allocated between regulated and non-regulated activities in accordance with cost causation principles. Overland analyzed the expenses in detail, and devised an allocator based on such principles. This analysis resulted in a reduction to operating expense of \$3.7 million in 1998 and 1999 on an intrastate after-tax basis.

As with the depreciation expense we discuss in the previous section, Pacific's defense is that it "allocated product advertising expense according to the Cost Allocation Manual as discussed in Section VI."²⁰⁹ We accept Pacific's position and reject the audit recommendation on the same basis as we set forth in the previous section.

(6) External Relations Costs Assigned to Regulated Operations

Overland states that the majority of the external relations costs in Pacific's account number 6722 were improperly assigned directly to regulated operations.²¹⁰ These costs were incurred by Pacific's parent, and involved the

²⁰⁸ This discussion refers to issues referenced as index 61 in Appendices A, B, C and D.

²⁰⁹ *Id.*

²¹⁰ This discussion refers to issues referenced as index 47 in Appendices A, B, C and D.

following activities: federal and state government relations, including California state political and legislative influence activities; executive oversight of external affairs, corporate policy and carrier relations; and FCC regulatory relations.²¹¹

None of these activities appear to have been appropriately recorded to Pacific's California regulated operations.

²¹¹ Exh. 2A:404 at 20-26 (Audit Report).

Pacific's brief addresses a different issue and is of no assistance to us here.²¹² Nor does it appear Pacific's witness addressed the issue. However, Pacific concedes elsewhere that audit adjustments for political and legislative influence and regulatory affairs are appropriate when the regulated utility carries out the activities.²¹³ If we were to allow Pacific to charge such activities to the regulated utility when an affiliate carries them out, we would encourage Pacific to transfer functions to affiliates for inappropriate reasons. Pacific's regulated operations should not be charged differently depending upon which entity engages in the legislative and regulatory activities. Moreover, we have ruled that regulated operations should not show such expense.²¹⁴

We agree with Overland's recommendation that California regulated operations not bear the expense of political and legislative influence activities and other external relations expenses. It may indeed be the case that Pacific does not dispute the audit findings, which we hereby adopt. The intrastate after-tax amounts are \$8.6 million in 1997, \$10.0 million in 1998, and \$4.2 million in 1999 on an intrastate after-tax basis as shown in Appendix A.

²¹² In the section of its brief headed "Account 6722 External Relations," Pacific actually discusses the next issue on our list, allocation of Customer Service expense in Account 6623.

²¹³ See Appendix C to this decision, reflecting undisputed issues including "Parent Political and Legislative Influence Expense."

²¹⁴ D.94-06-011, 153 PUR 4th 65 (1994), 1994 Cal. PUC LEXIS 456, at *116 (noting that Pacific records and should continue to record dues, donations and political advocacy expenses below-the-line).

(7) Allocation of Customer Service Expenses²¹⁵

Overland states that Pacific misallocates Customer Service expense between regulated and nonregulated cost categories. The account containing this expense contains a significant amount of Pacific's salary and wage costs, so the dollar amounts are significant – in the hundreds of millions of dollars. However, Overland concludes that, “because the flaws produced offsetting allocation errors, the overall regulated and non-regulated allocation results were reasonable.”²¹⁶

Pacific highlights this conclusion and urges us to make no changes to its policy. It explains that “Overland oversimplifies the allocation process and presents skewed analytical results”²¹⁷ Because we do not have an adequate record to determine whether Overland's adjustments to the allocations are sound, and because ultimately the regulated/nonregulated allocations are reasonable, we make no change to Pacific's current practice.

Overland notes that during the audit period, Pacific Bell tracked expenses it incurred in marketing telephone services in GTE's (now Verizon's) service territory in a way that indicated it planned to charge these expenses in whole or part to Pacific's regulated business. Overland suggests that we clarify now that Pacific will not be able to recover these costs from regulated services customers, “since [the costs] are not a cost of conducting business within Pacific Bell's

²¹⁵ This discussion refers to issues referenced as index 62 in Appendices A, B, C and D.

²¹⁶ Exh. 2A:404 at 20-27 (Audit Report).

²¹⁷ Pacific Opening/Audit at 173.

franchised service territory. ”²¹⁸ We agree that Pacific should not reflect these costs in its regulated operations, recover the costs from its regulated customers in Pacific’s service territory, or reflect the costs in earnings of the regulated entity.

Overland recommended that we increase regulatory after-tax expenses to reflect a greater allocation of customer service expenses to regulation operations. We adopt this change as reasonable. The intrastate regulatory after-tax amounts are \$1.0 million in 1997, \$3.4 million in 1998, and \$4.8 million in 1999.

(8) InterLATA Service Application Costs

Overland recommends that the Commission “consider whether costs associated with applying for interLATA service should be charged to regulated operating income or be charged to SBC’s interLATA long distance subsidiary.”

Pacific responds that, “because providing interLATA service is regulated by the Commission (and the FCC), ‘Pacific’s application to change the nature of that regulation was considered a regulated activity.’”²¹⁹ It also accuses Overland of improperly trying to change policy.

It appears the costs were properly charged to regulated operating income. The portion of the audit devoted to this issue is one paragraph. Therefore, we lack an adequate record to adopt Overland’s recommendation.

(9) Fluctuation Analysis

This issue deals with whether Pacific maintains documentation of a “fluctuation analysis” of its CPUC Cost Allocation System (C-CASS) or CPUC

²¹⁸ Exh. 2A:404 at 20-7 (Audit Report).

²¹⁹ Pacific Opening/Audit at 174, quoting Exh. 2B:338 at 45 (Ellis Direct Testimony).

Product Cost Allocation System (P-CASS), and other concerns about Pacific's fluctuation analysis process. Pacific performs fluctuation analyses to show changes from month to month in the assignment of costs to regulated and nonregulated categories. Overland found Pacific's documentation lacking in several respects and recommended that the Commission order Pacific to document its results to provide an adequate audit trail.

Pacific's response deals only with Overland's recommendations regarding the C-CASS and P-CASS systems, and not its criticisms of Pacific's other fluctuation analyses. On that issue, Pacific appears to claim that the C-CASS and P-CASS analyses are not necessary because Pacific performs a higher level analysis for the CASS.²²⁰ However, this argument ignores Overland's statement that even at the CASS level, "the fluctuation explanations that were obtained simply stated the cause of the fluctuation in generic terms The fluctuations did not focus on specific explanations from operations that would explain what products or marketing initiatives were causing the resulting monthly fluctuations."²²¹

We order Pacific to make a compliance filing within 90 days of this decision's effective date explaining in detail its fluctuation analysis process and addressing more specifically the auditors' concerns regarding the lack of specificity or a proper audit trail. In Phase 3B of this proceeding, we will then determine whether Pacific's method requires change.

²²⁰ See Exh. 2B:338 at 46-47 (Ellis Direct Testimony).

²²¹ Exh. 2A:404 at 20-16 (Audit Report).

(10) C-CAM Updates

Overland states that Pacific's Commission Cost Allocation Manual (C-CAM) is not sufficiently up-to-date and that certain descriptive information is missing. Overland states that responsible Pacific staff acknowledged the need to update the C-CAM. Pacific's staff also identified certain listings in the CAM that required updating, although Overland found the listings the staff identified to be inadequate. Further, Overland claims Pacific's staff told its auditors that certain aspects of the C-CAM had not been updated since 1996.

Pacific testified, to the contrary, that all aspects of the C-CAM were updated in December 2000, and that this update is adequate. We cannot reconcile Pacific's testimony with Overland's representation that Pacific staff informed it that the updates occurred in 1996 and identified areas needing updating. We find Pacific's testimony more credible and therefore reject Overland's recommendation.

(11) Subsidiary Account Translation Data

Overland suggests that Pacific maintain an audit trail translating the trial balances of its individual subsidiaries to Pacific's FR book (the books it uses to derive the IEMR report). Overland explains that Pacific reports the overall financial results of its Pacific Bell Information Systems (PBIS)²²² and Pacific Bell Network Integration (PBNI) subsidiaries in the FR books, but that it does not

²²² It is unclear whether this subsidiary is the same as Pacific Bell Information *Services*, which is the provider of Pacific's voice mail services. We assume it is for purposes of this discussion.

maintain detail about how it translates the subsidiaries' trial balances to the FR books. It claims this is a significant internal control weakness within Pacific's financial reporting structure."²²³

Pacific points out that Overland found no errors in Pacific's translation data, and therefore that the additional detail is unnecessary. Most importantly, Pacific states that "[t]he underlying detail is irrelevant as the entire costs and revenues for both of these subsidiaries were removed from regulated intrastate operations on the IEMR."²²⁴ Pacific shall also implement its proposed of action, including any change(s) the Commission orders.

It appears that PBIS (Pacific's voice mail provider) and PBNI (Pacific's provider of networking solutions primarily to business customers) have a significant financial impact on Pacific's business. Therefore, we believe the financial data regarding these subsidiaries' impact on the IEMR should appear in detail so that we have the opportunity to determine how Pacific calculates its IEMR results. Accordingly, we adopt the audit recommendation and require Pacific to make a compliance filing within 90 days of the effective date of this decision detailing how it will make more transparent and auditable the process it uses for translating PBIS' and PBNI's financial trial balances to its FR books and IEMR reports.

²²³ Exh. 2A:404 at 20-15 – 20-16 (Audit Report).

²²⁴ Exh. 2B:338 at 48:15-17 (Ellis Direct Testimony).

(12) Enhanced Sales Time Reporting Systems (ESTRS)

Overland suggests that Pacific include the PBNI results in its Enhanced Sales Time Reporting System (ESTRS) process. After 1998, Pacific ceased doing so. Pacific uses ESTRS as a statistically valid sampling process to determine the allocation of marketing hours between regulated and nonregulated work activities. Overland concluded that, “it is unlikely that the omission had a large impact on the overall distribution of activities between regulated and non-regulated categories.”²²⁵

Pacific responds that PBNI’s status changed when it became a part of Pacific in September 1998. At that time, all PBNI personnel automatically reported all of their time to a nonregulated tracking code, so study of how to divide their time between regulated and nonregulated activities was no longer necessary.

We agree with Pacific that if all of the PBNI personnel’s hours are reported to a nonregulated tracking code, there is no need to include them in the ESTRS process. We therefore decline to take any action on the audit comments in this regard.

VI. Audit Discovery Disputes

The April 24, 2002 ruling of then assigned commissioner Lynch ordered a distinct hearing phase to address allegations that Pacific impeded the audit. Overland did not allege that Pacific “impeded” the audit but explained that parts of the audit were made “very difficult”:

²²⁵ Exh. 2A:404 at 20-45 – 20-46 (Audit Report).

[R]estrictions that Pacific Bell imposed on the data it considered to be relevant and within the audit scope, data request response times that averaged more than two months

and sometimes extended for many months, and, notwithstanding objections to requests based on scope or relevance, Pacific Bell's inability or unwillingness to provide certain information and data.

The restrictions imposed on the audit prevented us from obtaining sufficient data to develop conclusions in some areas.²²⁶

Overland submitted 1,300 data requests to Pacific, over 1,000 of which were applicable to Phase 2B issues. The total data requests further broke down into approximately 10,000 subparts (asking for documents, person most knowledgeable, referencing separate affiliates as well as multiple years). Of the 10,000 subparts, approximately 8,000 applied to Phase 2B. Pacific provided Overland with 172,000 pages of paper and the equivalent of 19 million pages of documents via electronic media.²²⁷ Given the volume and complexity of the data requests, there is no doubt that responses required an extraordinary amount of time and resources by Pacific.

Pacific claims that Overland's methodology is flawed and its calculations for actual responses times skewed. We agree. Overland used calendar days instead of business days to compute the amount of time Pacific took to respond to a data request. This methodology added 40% more days to the total outstanding days calculated for a completed request. Overland also counted a data request as incomplete unless responses were provided to all subparts.

²²⁶ Exh. 2A:404 at 1-4 (Audit Report).

²²⁷ Hogue Corrected Testimony, Pacific: Phase 2B:346, p. 14.

Objections by Pacific were further deemed non-responses by Overland. We find that these methodologies unfairly suggest Pacific's response times were longer than necessary.

We also find that Pacific's exercise of its right to object to data requests on grounds of relevance, scope and privilege was proper. Data requests pursuant to Public Utilities Code § 314 are deemed presumptively valid, material and relevant. Pub. Util. Code § 314 provides broad discretion to:

[t]he commission, each commissioner, and each officer and person employed by the commission [to], at any time, inspect the accounts, books, papers, and documents of any public utility. [This provision] also applies to inspections of the accounts, books, papers and documents of any business which is a subsidiary or affiliate of. . . a . . . telephone corporation with respect to any transaction between the . . . telephone corporation and the subsidiary, affiliate, or holding corporation on any matter than might adversely affect the interests of the ratepayers of the . . . telephone corporation.

Utilities, nonetheless, are entitled to make timely objections to data requests associated with a Commission proceeding. To resolve just such disputes, the Commission created a Law and Motion Procedure.²²⁸ ALJ Resolution 164 clearly states:

²²⁸ ALJ Resolution 164, available at http://www.cpuc.ca.gov/word_pdf/FINAL_RESOLUTION/2538.doc

Applicability. These procedures are applicable to any formal matter pending before the Commission including applications, complaints, investigations and rulemakings. Rulings under law and motion.

Of the 1,300 data requests, Pacific timely objected to 65 on grounds of privilege, scope and/or relevance. It appears that the discovery disputes result from the failure to resolve the objections during the audit.

Objections to data requests made by staff of the Commission or its agent, Overland, should have been promptly resolved pursuant to ALJ Resolution 164.²²⁹ Despite the clear applicability of this procedure, neither Overland nor the Commission filed a motion to compel; Pacific, in turn, did not file a motion to limit the scope of discovery.

Objections by Pacific based on the audit scope and relevance were also, in large part, precipitated by the Commission initially distributing the wrong version of D.00-02-047, which defined the audit scope. The correct version of D.00-02-047 in fact limited the scope of the audit in vastly different ways than the previously distributed version. As such, Pacific properly exercised its right to object.

Commission staff, consistent with its interpretation of the Commission's Rules of Practice and Procedure, did not believe that it could file a Motion to Compel the production of data. Pacific, on the other hand, relying on ALJ Resolution 164, had no reason to provide the data without a clear ruling compelling its provision. In addition, Pacific did not file a Motion to Limit

²²⁹ Mineral Energy Company

Discovery, a path permitted under ALJ Resolution 164. As a result, the discovery dispute festered leading to this inquiry concerning whether Pacific obstructed this proceeding.

In any event, as previously discussed, we sustain those objections of Pacific based on the attorney-client privilege. Moreover, we sustain Pacific's other objections because D.00-02-047 limited the scope of the proceeding. In addition, to the extent that remaining issues surround affiliate relations, there is no information that suggests that they would prove material.

In addition, as our reasoning makes clear, Pacific acted consistent with ALJ Resolution 164. For these reasons, we find no basis to conclude that Pacific impeded the audit.

The course of this discovery dispute is not one which we wish to travel in the future. In any future discovery dispute with staff in this proceeding, Pacific shall file a motion to limit discovery, and not wait for Commission staff to file a motion to compel. Staff shall respond to such a motion.

VII. Phase 2B Remedies (Audit – Pacific Bell)

A. ORA's Proposed Remedies - Summary

ORA proposes the following remedies, which we discuss in more detail below.

- Pacific should correct the IEMR reports for 1997, 1998 and 1999 to reflect all of the audit adjustments adopted by the Commission.

We order this remedy.

- Pacific should correct its IEMR reports for 2000 and 2001 consistent with the adjustments we require for the 1997-99 reports.

We order this remedy.

- Pacific should share earnings for 1997 and 1998 if its earnings exceed the sharing threshold.

We order this remedy.

- Pacific should pay 18 percent interest on top of the amount it shares in earnings for 1997 and 1998, in the form of a surcredit.

We do not order this remedy.

- For 1999, Pacific should refund the earnings that would have been shareable had the Commission not suspended sharing in 1999. One means of effecting refunds would be to apply a limited exogenous factor adjustment.

We do not order this remedy.

- Pacific should refund 18 percent of all underreported earnings for the audit years, regardless of whether earnings met the sharing threshold for 1997-98, and regardless of the Commission's suspension of sharing in 1999.

We do not order this remedy, but invite input in Phase 3B on the how the Commission can deter such under-reporting and create incentives for accurate reporting in the future.

- The Commission should lift the suspension of sharing and establish a memorandum account to track excess earnings subject to refund.

We do not order this remedy.

- The Commission should order the 1997-99 audit completed with respect to affiliate transactions, and order Pacific to cooperate fully with the auditors' requests for information.

We do not order this remedy.

- The Commission should order a further audit of Pacific's 2000, 2001 and 2002 reporting, including its affiliate transactions.

We do not order this remedy.

- The Commission should impose a \$20 million annual payment on Pacific as an incentive for Pacific to cooperate with the completion of the 1997-99 affiliate transaction audit and the carrying out of the 2000-02 audit, until it deems Pacific to be cooperating fully with both audits.

We do not order this remedy.

- The Commission should institute a penalty phase to determine whether Pacific violated the affiliate transaction rules and Public Utilities Code § 2891 regarding disclosure of residential customers' information, and, if so, whether to order penalties or other relief.

We do not order this remedy.

- The Commission should revise its NRF monitoring report program to ensure we are receiving the information we need for effective monitoring and to eliminate reports we no longer need.

Consistent with the scoping memo, we defer this task to Phase 3B.

Preliminarily, Pacific criticizes ORA for proposing remedies that are inconsistent and subject to change on a whim. Pacific cites the many changes in the proposed remedies to demonstrate that ORA's proposals lack a reasonable basis. This decision is not concerned with what ORA proposed in Phase 2A, so we focus only on remedies proposed in Phase 2B. While there are small differences among the various ORA proposals, we find that for the most part, ORA recommends that Pacific correct the errors in its IEMR reports and pay an additional 18 percent as either interest or an "incentive" to ensure proper performance in the future.

Nor do we believe ORA's proposed remedies lack a reasonable basis simply because they have evolved over time. While we reject several of ORA's proposals, we do so based on the merits of each. We now turn to the individual suggested remedies.

B. Correction of IEMR Reports for 1997-99

ORA first contends that Pacific should correct the IEMR reports for 1997, 1998 and 1999 to reflect all of the audit adjustments adopted by the Commission. We agree that even where the changes do not cause Pacific to share earnings, the integrity of its books and records, and the regulatory process, must be preserved. Therefore, we order Pacific to make each of the changes we discuss in this decision. Pacific shall update its reports no later than 90 days following the effective date of this decision, submit the updated reports as a compliance filing in this proceeding, and also file them in the manner it files its other IEMR reports as they come due.

1. Correction of IEMR Reports for 2000-2001

Next, ORA states that Pacific should correct its IEMR reports for 2000 and 2001 consistent with the adjustments we require for the 1997-99 reports, pursuant to Resolution T-16571, in which we accepted Pacific's rate of return for 2000 subject to corrections or adjustments that may result from this proceeding. It is unclear whether Pacific opposes this request.²³⁰ We grant this remedy.

We agree with ORA that many of the changes we order to the 1997-99 IEMR reports also apply to subsequent years. If we were to limit the required changes to the IEMRs issued during the audit period, regulatory accounting that we have already found to be in error would continue into the future. Just the

²³⁰ Pacific's Opening Brief contains an entry in the table of contents stating "ORA's proposal that Pacific submit revised IEMR annual reports for years 2000 and 2001 should be rejected," but the body of its briefs contain no such discussion.

opposite should occur: Pacific should be required to change its IEMRs for 2000 forward and continuing until otherwise specified by the Commission.

Pacific shall therefore correct its IEMRs for years subsequent to 1999 consistent with this decision. Pacific should file the correct reports no later than 90 days following the effective date of this decision in the manner it files its other IEMR reports as they come due, and also submit the updated IEMRs as a compliance filing in this proceeding.

Moreover, several of the changes we make here do not relate to one-time events that will not recur. Rather, we order many changes in the way Pacific keeps its books and reports its revenues and expenses on an ongoing basis. To the extent the changes we order affect Pacific's ongoing reporting for 2001 forward, it would hurt ratepayers and the regulatory process for us to allow Pacific to continue disallowed practices. Therefore, we will require Pacific to amend its IEMRs and other processes to demonstrate that it is not continuing the practices that we find objectionable or improper in this decision.

Pacific shall make a compliance filing within 90 days of the effective date of this decision listing each finding from this decision that has ongoing effects for its record-keeping, reporting or other activities, declaring that it is no longer engaged in disallowed practices, and demonstrating that its practices for 2001 forward comply with this decision.

2. Sharing in 1997 and 1998

ORA contends Pacific should share earnings for 1997 and 1998 if its earnings exceed the sharing threshold. Implicit in this proposal is the recommendation that Pacific change its IEMRs retroactively in the affected years, rather than making "catch-up" adjustments now.

We agree that Pacific should recalculate earnings for 1997 and 1998 based on the audit corrections we order it to make here. If we simply reverse the ratepayers will not be made whole. Rather, we find that GAAP does not preclude us from making changes to the IEMR in the affected years, as we discuss fully in the Section entitled “Pacific’s Books and Generally Accepted Accounting Principles,” above.

C. Interest on 1997-98 Shareable Earnings

On top of any earnings sharing Pacific is required to make after re-calculating its financial results for 1997 and 1998, ORA proposes that Pacific also pay 18 percent interest on the shareable amount. ORA chose the 18 percent figure by examining what Pacific charges its customers for late payments. Since ratepayers will receive any shared earnings belatedly, ORA reasons that it is fair to order Pacific to compensate them in the same way it would be compensated if the shoe were on the other foot.

Pacific contends it should pay interest based on the 90-day commercial paper rate. It cites D.01-06-077, in which the Commission ordered Roseville Telephone Company to share earnings retroactively and pay interest based on the amount ordered in D.89-10-031, which was the 90-day rate. Pacific claims ORA’s reliance on the 18 percent figure is arbitrary and effects a penalty on Pacific rather than simply compensating ratepayers for the time value of money. Pacific also notes that its customers agree to the late payment charge, while arguing that here, ORA seeks to impose a rate retroactively that was never disclosed to or agreed upon by Pacific. It contends ORA agreed on the 90-day rate in Phase 2A of the proceeding.

We decline to impose the 18 percent interest rate requested by ORA. ORA conceded in Phase 2A that the proper interest applicable to the shareholder

earnings calculation established in D.89-10-031 is “the 90 day commercial paper rate published by the Federal Reserve Statistical Release.”²³¹ In D.01-06-077, the Commission in fact ordered that shareable earnings include interest calculated in accordance with D.89-10-031:

Interest shall be based on the 90 day commercial paper rate as published by the Reserve Statistical Release and shall be calculated using the methodology and formulas as discussed and set forth in D.88-09-028 for the labor productivity sharing for Pacific and GTEC.²³²

Similarly, we adopt the 90 day rate Pacific proposes here. We order that Pacific pay the 90 day rate on top of any shareable earnings it is required to pass on to ratepayers for 1997 and 1998. Pacific shall record the refund of sharable earnings and the interest thereon that it is required to pay as a result of this decision and the Phase 2A decision below-the-line.

Such treatment is consistent with the Commission’s treatment of shareable earnings in D.89-10-031. In that decision, the Commission stated that a “ratemaking adjustment may be required in a year in which a prior year’s excess earnings are returned to ratepayers through the sharing mechanism, to prevent the return of earnings from depressing current year earnings in the sharing calculation.”²³³ Thus, it was clearly the Commission’s intent that shareable earnings in a prior year should not distort reported earnings in a subsequent

²³¹ Lee-Whei Tan Opening Testimony, Exh. ORA:Phase 2A:109, p. 6.

²³² D.89-10-031, Ordering Paragraph 16.

²³³ D.89-10-031, 33 CPUC 2d 43, 186 (1989).

year. Likewise, the interest that Pacific owes on shareable earnings should not distort reported earnings.

D. Method of Payment

ORA recommends that ratepayers be credited the shareable earnings plus interest in the form of a one-time payment applied as a surcredit in the billing charges set forth in Pacific's tariff in Schedule Cal. P.U.C. Rule No. 33.²³⁴ That Rule lists Pacific's billing surcharges, and seems to be an appropriate place to list the surcredit we order here. ORA recommends that the surcredit be applied uniformly across local exchange services and residential intraLATA toll services, "which includes the original end-user basic monopoly services where Pacific still holds a dominate [sic] market share."²³⁵ Other than opposing the entire concept of our requiring sharing and ORA's recommended rate of interest, Pacific does not oppose ORA's specific suggestion. Our original decision establishing NRF stated that "Any shared earnings will be returned to ratepayers through a surcredit on bills for basic end user monopoly services."²³⁶

We agree with ORA's suggestion, and will require that Pacific reflect the surcredit in Rule 33 of its tariffs. This refund mechanism is consistent with the procedure adopted in D.89-10-031²³⁷ for returning shareable earnings to

²³⁴ Pacific's tariffs, including Rule 33, are available on its website at http://www.sbc.com/Large-Files/RIMS/California/Network_and_Exchange_Services/ca-ne-02.pdf, at sheet 135 *et seq.*

²³⁵ ORA Opening/Audit at 81.

²³⁶ D.89-10-031, 1989 Cal. PUC LEXIS 576, at *6.

²³⁷ 1989 Cal. PUC LEXIS 576.

end-users. In that decision, the Commission required that shareable earnings should be made through a bill and keep surcredit to all Category I basic monopoly services, excluding switched and low speed special access and other services normally excluded from surcredits. This process returns any shared revenues to end-users in a practical, fair, and equitable manner. While there have been substantial recategorization of services from Category I since the Commission rendered its decision in D.89-10-031, the rationale of flowing shareable earnings and applicable interest to end users is the same today as it was previously. Consequently, regardless of the category that the above services reside in, Pacific shall follow the procedure adopted in D.89-10-031 to return to ratepayers the shareable earnings adopted in this decision and the Phase 2A decision.

Only end-user customers – and not purchasers of intermediary services such as access services and UNEs – shall receive the benefits of the surcredit. In D.98-09-039, we chose a three month surcredit in connection with a refund of approximately \$400 million by balancing the interests of “(1) customers of the large LECs who would not fully benefit from a surcredit of longer duration because they would not remain customers of the large LECs for more than three months, and (2) customers who would not fully benefit from a surcredit of shorter duration because they happen to have an unusually small amount of usage or charges during the period the surcredit would be in effect.”²³⁸

²³⁸ D.98-09-039, 1998 Cal. PUC LEXIS 971.

We believe that balancing the interest of the same two classes of customers is appropriate, but in view of the large size of the surcredit in this case, we find it is most prudent to extend the credit over a 12-month period, commencing no later than 120 days from the effective date of this decision. In this way, we avoid the “rate shock” that may occur after a short surcredit period in which customers receive significantly discounted bills. With a 12-month period, the credit each ratepayer receives each month will still be significant, but the transition back to regular rates will not be as drastic.

E. Suspension of Sharing in 1999

ORA and TURN claim Pacific misled us into suspending sharing in 1999 by presenting an inaccurate picture of the likelihood of sharing in the future. Had the Commission left sharing in place – as ORA and TURN contend it would have had it known the true facts – ratepayers would also benefit from the 1999 earnings adjustments we make in this decision.

There are two aspects to this claim. First, ORA contends that the expense overages that the audit reveals gave the Commission an inaccurate picture of whether sharing was a necessary mechanism. Pacific’s reported expenses always were high enough – and its earnings correspondingly low enough – that it never was forced to share earnings with ratepayers. Had Pacific reported its expenses correctly, ratepayers may have shared in Pacific’s earnings and the Commission would have had a better sense of the necessity for and benefits of sharing.

Second, ORA and TURN claim Pacific submitted misleading evidence in the proceeding in which the Commission decided to suspend sharing. They claim Pacific projected that its future earnings would not rise to the sharing threshold except under extraordinary circumstances. Therefore, they claim Pacific unfairly convinced the Commission that sharing was not necessary.

ORA suggests that we order Pacific to refund the earnings that would have been shareable had the Commission not suspended sharing in 1999. It states that one means of effecting refunds would be to apply a limited exogenous (LE) factor adjustment.

Pacific claims that to reinstate sharing in 1999 would constitute illegal retroactive ratemaking and would be inconsistent with the purposes of NRF. It also refutes ORA's factual claims, asserting that it fully informed the Commission of the potential for outcomes well above the sharing threshold before the Commission suspended sharing. Pacific also claims we cannot order refunds to ratepayers without meeting the nine LE criteria discussed in the Section entitled "Recovery of Audit Costs," below, and argues that the proposed refunds do not meet those criteria.

We are not prepared to find that the Commission should not have suspended sharing in 1999. To do so would require a reexamination of the entire record leading up to D.98-10-026, our decision suspending sharing, to determine the full basis for the Commission's decision and the evidence it had before it. Nor can we state with any certainty that the Commission would have done anything differently had it had the benefit of the Overland audit.²³⁹

This does not mean that we will not make 1999 audit adjustments that we find supported by the evidence. We will require Pacific to make these adjustments to the 1999 IEMR report. There may be other ratepayer impacts that we cannot now anticipate from this result. If Pacific received any rate increases or had any rate floor changed as result of its reported 1999 IEMR results, or based any such request in whole or part on such results, it shall call those to our attention in its compliance filing due 90 days after the effective date of this

²³⁹ We also declined to change our decision to suspend sharing in analyzing Overland's audit of Verizon in Phase 1 of this proceeding. *See* D.02-10-020, *mimeo.*, at 48.

decision. Any party may comment on that filing with 30 days, and suggest remedies and identify other possible effects of Pacific's incorrect reporting. Pacific shall also include the same information for 1997 and 1998 in its filing.

F. Proposed 18 Percent Interest on All Underreported Earnings

In addition to suggesting that we impose 18 percent interest on Pacific's shareable earnings – if any – for 1997-98, ORA also recommends that we order Pacific to pay 18 percent on all underreported earnings for the entire audit period 1997-99. This suggestion differs from ORA's earlier 18 percent remedy because it would apply not only to amounts returned to ratepayers in the form of sharing, but also to amounts that fall below the sharing threshold. For 1999, this 18 percent would be the only remedy beyond requiring Pacific to correct its accounting errors because Pacific was not required to share earnings in that year, and because we decline to impose sharing retroactively for 1999.

We deny ORA's suggested remedy for 1997-98. Assessing 18 percent on the additional earnings under the sharing threshold would overcompensate ratepayers by giving them more than they would have received had Pacific reported its earnings correctly in the first place. Under the sharing mechanism, ratepayers share only in earnings above a certain threshold. Ratepayers by definition receive no amount of earnings below the threshold.

The only justification for imposing the 18 percent on earnings below the threshold – or on any earnings Pacific had and did not report for 1999 – would be

to penalize Pacific, or provide other financial incentives for it to report its financial information accurately.

ORA cites *Wise v. PG&E*²⁴⁰ for the proposition that we may fashion an appropriate remedy where a utility has obtained a rate by fraud.²⁴¹ We do not have an adequate basis in the record currently before us to conclude pursuant to the authority ORA cites that Pacific committed fraud in underreporting its earnings or convincing the Commission to suspend sharing in 1999. Therefore, we do not believe *Wise* forms a basis to impose the 18 percent figure on earnings below the sharing threshold.

ORA also cites Pub. Util. Code § 798, which allows us to impose civil penalties on carriers that willfully make imprudent payments to or receive less than reasonable payments from subsidiaries, affiliates or holding companies. We do not have a record before us to justify imposing such a penalty. Thus, we decline to impose the 18 percent figure on any underreported earnings figures for 1997-99.

Over the years, we have adopted financial penalties as an incentive to ensure compliance with our rules, including those related to financial reporting. For example, in our recent decision on Pacific's application pursuant to § 271 of the federal Telecommunications Act of 1996,²⁴² we described the self-executing financial performance incentives Pacific faces to ensure that it complies with the

²⁴⁰ 77 Cal. App. 4th 287 (1999).

²⁴¹ ORA Reply/Audit at 55.

²⁴² 42 U.S.C. § 271.

§ 271 requirement that it give competitive local exchange carriers equal access to the ordering, repair, billing and related systems they need to provide local telephone exchange service to customers.²⁴³

Our discussion of these accounting issues, however, reveals that they are arcane. This makes it virtually impossible to design an incentive program since we cannot clearly state the behavior we wish to encourage. Furthermore, since this decision and the Phase 2A decision result in no shareable earnings, we see little benefit to devoting additional regulatory resources to designing an incentive program on this matter.

G. ORA Proposal to Reinstate Sharing

We do not have an adequate record to determine whether the Commission should reinstitute ratepayer sharing, as ORA contends we should. ORA's only evidence in support of its claim is the same evidence it relies on – and we reject – in favor of our reinstituting sharing for 1999. Because we do not believe that evidence gives us an adequate record to require the reimposition of sharing going forward, we deny ORA's suggested remedy. However, this decision does not mean that we cannot consider the reimposition of sharing in Phase 3B.

H. No Additional Auditing of 1997-99 Transactions Needed

Overland recommends that it be allowed to supplement its 1997-99 audit of Pacific's affiliate transactions. Pacific notes that ORA's expert did not even

²⁴³ D.02-09-048, Sept. 19, 2002, *mimeo.*, at 226 *et seq.* See also D.02-04-055, 2002 Cal. PUC LEXIS 285, at *7-8 (describing measures that either reward or penalize electric utility for performance in connection with incentive based ratemaking); R.98-06-029, 1998 Cal. PUC LEXIS 428, at *8 (describing incentives used to penalize poor telephone company service quality).

recommend the years 1997-1999 be revisited by an audit.²⁴⁴ We reject this recommendation. The results from the audit demonstrated no material impact from affiliate transactions. There is no need to devote further resources to audit transactions from these three years.

I. Audit of Pacific's 2000-02 Reporting Should Commence When Ordered

We will separately consider commencement of the next triennial review under NRF of Pacific's performance covering the years 2000 forward, including affiliate transactions.²⁴⁵ Therefore, we do not order a separate audit for the years 2000 and beyond as part of Phase 2B of this current review. Rather, the next audit – including an examination of Pacific's affiliate transactions for the period 2000-02 – will occur as part of the normal NRF triennial review process. We reiterate what we said in our Phase 1 decision regarding Verizon. The same process shall apply to Pacific:

Audits are an essential part of NRF. They provide a means for the Commission to monitor utility financial performance, to determine if utilities are complying with Commission rules and statutory requirements, and to assess whether the Commission's goals for NRF are being met.

²⁴⁴ 11 TR 1143:25-1144:2; 13 TR 1392:26-1393:25.

²⁴⁵ We note the auditors' conclusion here that the magnitude of the affiliate transactions really did not grow until 2000, the year after the audit period ended. If we are truly to ensure that the problems the audit began to unearth are not continuing – and to verify Pacific's claims to have improved its own internal controls – we believe an audit of the post-audit period years is necessary. We therefore order that the next triennial review include an affiliate transactions audit.

[E]ven if no problems had been found, it is prudent for the Commission to maintain continuous, comprehensive, and vigilant oversight of large utilities like Verizon [and Pacific] that provide essential services to millions of Californians.²⁴⁶

The Commission is required by Pub. Util. Code § 314.5 to audit Pacific at least every three years. Because Overland's audit report on Pacific that is before us in this proceeding was issued on February 21, 2002 (with the supplemental report issued on June 20, 2002), the Commission should promptly commence the next audit of Pacific in order to meet the statutory requirement of triennial audits.

J. \$20 Million "Incentive" Payment

ORA proposes that we impose a \$20 million annual payment on Pacific as an "incentive" for Pacific to cooperate with the completion of the 1997-99 affiliate transactions audit and the carrying out of a 2000-02 audit, until we deem Pacific to be cooperating fully with both audits.

We do not believe ORA's proposed \$20 million incentive payment requirement is anything other than a monetary hostage held to limit Pacific's ability to exercise its due process rights. ORA's proposal demonstrates a lack of judgment.

We found no obstructive behavior on Pacific's part. The proposed "incentive" is neither a necessary or reasonable means to ensure Pacific's cooperation with the audit.

²⁴⁶ D.02-10-020, *mimeo.*, at 54.

K. Penalty Phase

ORA also asks us to institute a penalty phase to determine whether Pacific violated the affiliate transaction rules and Pub. Util. Code § 2891 regarding disclosure of residential customers' information, and, if so, whether to order penalties or other relief.

It is premature to decide whether a penalty phase is warranted on Pacific's affiliate transactions compliance until the auditors complete the affiliate transactions review for 1997-99. ORA may renew its request after that audit is completed.

On the request for a penalty phase under Section 2891, we lack adequate evidence and briefing on the issue. Section 2891 provides that telephone corporations must obtain a residential subscriber's written consent before sharing the subscriber's personal financial, purchasing, and calling pattern information with another person or corporation.²⁴⁷ The only evidence in the record is that Pacific shares information about its customers with SBC Operations, a subsidiary of Pacific's parent, SBC, which in turn uses the information to conduct marketing and research on Pacific's behalf.

In D.01-09-058, we declined to reach a claim that Pacific violated § 2891 by this same conduct due again to the absence of an adequate record on the issue. Pacific claimed that there was an "agency" exception that allowed it to disclose customer information to SBC Operations and third parties conducting marketing on Pacific's behalf. We found that we could not rule on the claim because there

²⁴⁷ California Public Utilities Code § 2891(d) contains ten exceptions to this requirement, none of which are applicable here.

was insufficient evidence in the record. We initially stated that “Based on the plain language of the statute, this release of residential subscribers' personal information [to SBC Operations] appears to constitute a violation of § 2891.” Nonetheless, we concluded that “we cannot determine whether Pacific Bell's treatment of confidential subscriber information violated § 2891. As the burden of demonstrating that a violation was committed lies with complainants, we decline to find Pacific Bell in violation of § 2891 in this proceeding.”²⁴⁸

Similarly, the record before us here does not provide adequate information for us to decide the § 2891 issue. We therefore decline ORA's request seeking a penalty phase in this proceeding.

L. Revisions to NRF Monitoring Program

Finally, ORA asks the Commission to revise its NRF monitoring report program to ensure we are receiving the information we need for effective monitoring and to eliminate reports we no longer need. Consistent with the scoping memo, we defer this issue to Phase 3B.

VIII. Recovery of Audit Costs

Pacific is seeking to recover a portion of the costs it incurred as a result of the audit.²⁴⁹ Pacific is requesting recovery for the direct out-of-pocket costs paid by Pacific to the Commission based on billings submitted by Overland. The amount is expected to be just over \$2 million. Pacific proposes that recovery be

²⁴⁸ D.01-09-058, 2001 Cal. PUC LEXIS 914, at *109-110.

²⁴⁹ Hogue Corrected Direct Testimony, Exh. Pacific: Phase 2B:346, p. 14.

provided through inclusion of the total payments made to the Commission as a line item in Pacific's next Annual Price Cap Filing.

As the Commission noted in D.96-05-036, one decision addressing Pacific's effort to transfer audit responsibility away from DRA, ORA's predecessor, "In its petition [to modify D.94-06-011, which prescribed the audit], Pacific sought to have the audit performed under the supervision of the Commission's Advisory

and Compliance Division (CACD) [TD's predecessor]. *Pacific Bell also indicated its willingness to fund the CACD supervised audit.*"²⁵⁰ At the same time, however, the Commission provided that Pacific could later seek exogenous cost treatment for the audit.²⁵¹

Exogenous cost recovery allows a company to recover extraordinary costs in a process separate from the NRF price indexing mechanism itself. The company must satisfy nine criteria in order to qualify for such recovery.²⁵² The nine criteria are: (1) is the event creating the cost at issue exogenous?; (2) did the event causing the cost occur after the NRF was adopted in late 1989?; (3) is the cost clearly beyond management's control?; (4) is the cost a normal cost of doing business, even if it is increased by an exogenous event?; (5) does the event have a disproportionate impact on local exchange carriers?; (6) is the cost caused by the event reflected in the economy-wide inflation factor (GDPPI) used in the annual NRF price cap proceeding?; (7) does the event have a major impact on the utility's overall cost?; (8) can actual costs be used to measure the financial impact of the event, or can the costs be determined with reasonable certainty and minimal controversy?; and (9) are the proposed costs reasonable?²⁵³

²⁵⁰ D.96-05-036, 66 CPUC 2d 274 (1996), 1996 Cal. PUC LEXIS 657, at *9.

²⁵¹ *Id.*

²⁵² The Commission originally adopted these nine criteria, collectively known as Z-factors, in D.94-06-011, 55 CPUC 2d 1 (1994). In D.98-10-026, the Commission allowed Limited Exogenous (LE) Factor treatment as a replacement for the Z-factor.

²⁵³ D.94-06-011, 55 CPUC 2d 1, 36-41 (1994); D.98-10-026, 82 CPUC 2d 335, 1998 Cal. PUC LEXIS 669, § 7.2.3, n.23.

Pacific claims it meets all nine criteria. ORA asserts it fails to meet four of the criteria. TURN claims that audits are simply part of Pacific's regulatory compliance costs, are a normal cost of doing business, are not extraordinary and therefore do not warrant exogenous recovery under the fourth criterion.

Because all criteria must be satisfied, and we find that several are not, we only discuss here the criteria Pacific's claim does not satisfy. ORA contends that the claim for audit costs does not meet the third requirement that the cost clearly be beyond management's control. A finding against Pacific on this criterion might still allow Pacific some cost recovery, because at least some of the cost of the audit clearly was beyond such control.

ORA claims that much of the effort expended on the audit was due to Pacific's recalcitrance in responding to data requests and its general resistance to furnishing the auditors requested information. We discussed this general allegation in more detail in the Section entitled "Audit Discovery Disputes" and did not find that Pacific impeded the audit. However, because we find that Pacific fails to meet other LE criteria allowing it any audit cost recovery, we need not decide which costs, if any, were within management's control.

ORA also claims the costs do not meet criterion 7: "does the event have a major impact on the utility's overall cost?" ORA claims that given Pacific's strict view of what is "material" in other parts of its case (a view we reject elsewhere in this decision), Pacific ought to have to live by that view in calculating whether \$2 million has a major impact on Pacific's overall cost." We do not view the issue this way, and find that \$2 million does have a major impact.

ORA also questions whether actual costs can be used to measure the financial impact of the event, or whether the costs can be determined with reasonable certainty and minimal controversy (criterion 8). Because, ORA

contends, the audit is not even finished as to affiliate transactions due to Pacific's own resistance, it is impossible at this time to determine the actual costs. We disagree. At some point the total audit costs will be ascertainable with reasonable certainty and minimal controversy. By the same token, since we find that management could have controlled some of the costs under criterion 3, a determination of which costs Pacific should and should not recover will probably never be uncontroversial. For this reason, we find Pacific cannot satisfy criterion 8.

Finally, ORA questions whether the costs proposed for exogenous factor treatment are reasonable (criterion 9). Once again, ORA states that due to Pacific's unreasonable behavior, costs escalated far above what they would have been had Pacific been more cooperative. Because the costs were authorized by the Commission and the billing approved by the Telecommunications Division, Pacific argues that the costs are *per se* reasonable. Any costs that were entirely within the control of management would not be reasonably recovered from ratepayers. At least as to those costs, therefore, we find that Pacific has failed to prove entitlement to exogenous cost recovery.

The question then becomes whether we should disallow some or all of the audit costs. We find that such a determination is premature. Many of the exogenous cost factors we discuss above deal with whether the company seeking exogenous treatment has acted reasonably, unnecessarily increased the relevant costs, or contributed to a delay in the work generating the expense. We will consider a renewed request for exogenous treatment of the full amount of audit costs once this decision is final. Therefore, we defer ruling on Pacific's request at this time.

Comments on the Alternate Proposed Decision

The alternate proposed decision assigned to Commissioner Kennedy was mailed to the parties in accordance with Pub. Util. Code § 311(d) and Rule 77.6 of the Commission's Rules of Practice and Procedure. The following parties submitted comments and/or reply comments on the Commissioner's alternate proposed decision:

Findings of Fact

1. In 1997 and 1998, Pacific was under an obligation to share earnings above a certain threshold with ratepayers. In combination with the audit decision resulting from Phase 2A of this proceeding, the earnings did not rise to a level that requires Pacific to share earnings in 1998.
2. In 1999, Pacific also over-reported expenses, but was under no obligation in that year to share earnings with ratepayers.
3. In its audit report, Overland identified 72 corrections to Pacific's regulated operating revenues, expenses and rate base. This decision resolves all but 4 issues; the Phase 2A decision resolves the remaining 4 issues.
4. Pacific maintained its FR books during the audit period solely for the purpose of creating the Intrastate Earnings Monitoring Reports (IEMRs). Any GAAP changes instituted after 1995 are not reflected in the FR books. The only purpose of the FR books after 1995 was to create the IEMR, which constitute the regulatory scorecard for determining whether there are shareable earnings..
5. An adjustment to Pacific's IEMR in the current period – when sharing is no longer Pacific's obligation – is inconsistent with the intention of NRF to determine "shareable" earnings in the year in which they occurred.
6. During a period when revenue sharing is in effect, a reduction in the amount of net revenues shared with ratepayers economically impacts ratepayers.

The higher Pacific's costs as reported in the IEMR, the lower its revenues and ultimately its potentially shareable earnings.

7. Pacific's accounting costs can have an effect on the price floors and ceilings the Commission sets for its services. These floors and ceilings are set based on studies of Pacific's forward-looking costs, which in turn are often derived, in part, from accounting costs.

8. It is essential to the regulatory process that we have accurate information regarding the earnings of companies we regulate.

9. Materiality in the context of the audit is to be determined by the Commission. The Commission imposed a low threshold of materiality in this context in order to insure "full compliance with its rules and regulations."

10. Even if a single item of adjustment is immaterial, it may be material viewed in context with the other adjustments we order. Where, as here, the Commission's review may result in a cumulative adjustment in an amount that meets anyone's definition of material, then every issue should be deemed material.

11. Overland met the criteria for performance of this audit specified in D.96-05-036.

12. Those conducting the audit for Overland were qualified.

13. Overland failed to conduct the audit consistent with NARUC standards despite committing to such a practice in its proposal letter.

14. It remains troubling that Overland would commit to following NARUC auditing procedures and then fail to follow them.

15. Pacific had adequate opportunity to respond to the audit report.

16. While Overland did engage in lengthy policy discussions in its audit report, it made recommendations consistent with the Commission's desire for

“analysis of all issues uncovered,” “recommendations as to specific accounting measures” and a “thorough, aggressive audit.”

17. Overland has little expertise in interpreting Commission policies.

18. Any errors Overland made in its audit are inconsequential in an audit of this size.

19. Pacific conceded 20 out of 72 audit adjustments, at least to the extent of agreeing that the accounting treatment it used for purposes of its IEMR was incorrect.

20. The broad powers granted to the Commission under the Constitution do not exempt it from complying with the attorney-client privilege.

21. Pacific has claimed that information concerning its accruals for litigation liability are subject to the attorney-client privilege.

22. Information concerning Pacific’s accruals for litigation liability are subject to attorney-client privilege due to the nature of the accruals.

23. Pacific has done nothing in the present proceeding to place at issues its privileged communications.

24. Pacific has presented insufficient record to justify the accruals.

25. In 1996, Pacific implemented the new RCRMS automated bill collection system.

26. Pacific was aware of problems with RCRMS in 1996.

27. Other than in the period in 1996 at issue, Pacific’s bad debt did not fluctuate drastically as it did during the period at issue. The fluctuation put Pacific on notice of a serious problem in 1996.

28. In 1996, Pacific changed how it accounted for revenues and expenses related to published directories. Prior to then, it accounted for them over the life

of the directory. In 1996, it began recognizing revenue and expense when the directory is issued.

29. In April 1996, the Commission issued D.96-04-052, promising Pacific a true-up for recovery of past costs related to interim number portability.

30. Concerning Directory Publishing, Pacific accurately posted a one-time pre-tax gain of \$143 million in 1996.

31. Overland's extensive audit failed to identify any improper accounting for 1997, but it was unable to determine whether the change in accounting policy for Directory Publishing had an impact on reported revenues and expenses in 1997

32. Costs that are deferred as a regulatory asset do not appear on the IEMR as an expense. Because lower expenses increase earnings – and, potentially, sharing – while regulatory assets have little impact on earnings, the difference between an expense and a regulatory asset has great significance to Pacific's IEMR.

33. Since there was no specific LNP cost subject to recovery from the California regulatory jurisdiction prior to May 1998, FAS 71 and FAS 90 did not permit the creation of a regulatory asset since there were no specific costs for which recovery was reasonably assured.

34. In May of 1998, the FCC declared LNP costs subject to federal jurisdiction.

35. To account for LNP costs properly, Pacific should make an after-tax adjustment for LNP cost of \$15.6 million in 1998 and \$22.3 million in 1999.

36. Pacific lacked a regulatory promise of recovery of local competition implementation costs. This lack of a regulatory promise precluded the creation of a regulatory asset to cover these expenses.

37. Lacking a regulatory promise of recovery of local competition costs, Pacific properly expensed the audit amount of \$49 million.

38. Overland incorrectly concluded that Pacific would have realized savings as a result of Pacific Bell-SBC merger, imputed those savings to the business, and attributed 50% of the imputed savings to Pacific's shareholders. There is no proof that these savings actually materialized. Thus, there should have been no assumption that ratepayers would lose the 50% of imputed savings Overland decided should inure to the benefit of Pacific's shareholders.

39. In December 1999, Pacific entered into a new contract with Lucent for software right-to-use fees.

40. Since this was a new contract, the costs associated with it were properly accounted as expenses by Pacific.

41. For the years 1997-99, Pacific's overstated its intrastate operating expenses by \$29 million as a result of the over-accrual of incentive pay costs. Actual incentive pay was lower than the accrued amount.

42. Pacific's error in estimated expenses was reasonable, as were the procedures it followed to adjust accounts were consistent with GAAP, and reasonable.

43. There is no dollar impact related to the expense issue Overland calls a "royalty payment," and that Pacific titles a "management fee," but only a difference of opinion on how – rather than whether – Pacific should adjust the fee out of its intrastate regulated operations.

44. In 1997, Pacific recorded a \$12.6 million entry related to pre-1976 disabilities that Pacific's actuaries had not previously valued. Overland found that Pacific should not have made the entry in 1997, and that it artificially increased expenses by \$9.6 million in that year to the possible detriment of ratepayers. It is reasonable to adopt Overland's recommendation of \$5.7 million on an intrastate after-tax basis as shown in Appendix A.

45. The audit report proposes an adjustment to correct errors admitted by Pacific in its accounting for amortization of its intrabuilding network cable investment. All sides agree that Pacific made an error. There is a dispute only as to when Pacific should have accounted for the error. The error took place in each of the years 1994-1997. Pacific recorded a catch-up accrual in 1997.

46. Pacific acted reasonably in recording a catch-up accrual in 1997 for intrabuilding network cable investment to correct previous errors.

47. Overland found that Pacific overstated the rate base deduction for accumulated deferred income taxes (ADIT) by an average of \$7 million per year due to the improper use of “normalization” accounting.

48. Overland could not adequately audit Pacific’s intrastate regulated sales and use tax expense because Pacific contended the accruals depended only on “management’s professional judgment - nothing more, nothing less.”

49. The purpose of an audit is to test management’s judgments, and to ensure that all accounting transactions that raise questions are verified.

50. It is not correct in all cases that when subsequent events indicate that a previously recorded liability has been reduced or eliminated, a reversal is appropriate in the current period.

51. It is reasonable to adopt Overland’s audit adjustments concerning sales and use tax accruals. These adjustments on an after tax basis are \$461,000 in 1997, \$457,000 in 1998, and -\$1.4 million in 1999.

52. Pacific does not dispute the audit finding that when it processed certain manual paychecks, it failed to generate accruals for the employer’s portion of payroll taxes. Pacific made a catch-up entry in 1999 to correct the error, rather than reflecting a change in 1998 and prior periods.

53. It is reasonable to require that Pacific correct the timing of its payroll tax corrections as indicated herein and detailed in Appendix A.

54. Pacific does not dispute the audit finding that it overstated its intrastate regulated deferred income tax expenses by \$59 million in 1998 and 1999 as a result of an accounting error. Pacific corrected the error in 2000, rather than reflecting a change in 1998 and 1999, the affected years.

55. It is reasonable to correct the booking of deferred taxes so that taxes are booked in the year owed.

56. Pacific overstated by \$8 million in 1999 its current period intrastate operating income taxes and intrastate operating deferred income tax expense related to its severance of Ameritech employees. There is no disagreement that these costs should have been booked below-the-line.

57. It is reasonable to direct Pacific to restate its 1999 books to remove the current period and deferred income tax associated with the Ameritech severance accruals.

58. The FCC continuing property records audit, Pacific's 1999 computer inventory, and Pacific's 1997 SAVR audit of its central office property records, in combination, suggests that Pacific has an internal control problem in maintaining accurate property records during the audit period.

59. The SAVR audit in particular found that 4.5% of Pacific's recorded plant was not present in the central offices. Pacific also found plant in its central offices that did not appear in its plant accounts.

60. During the audit period, Pacific reported financial results of property it did not have, had property in inventory that it did not report, and generally lacked control over its property records and inventory.

61. For plant it could not locate, Pacific retired the assets from the company's books by crediting plant in service for the original cost of the item and debiting accumulated reserve for depreciation. This approach overstated depreciation in 1997 and 1998. Pacific should have recorded the corrections to its accounting in the affected years, not in subsequent years when it discovered the error.

62. Pacific assumed for plant it located in the central offices for which it had no record that it had never recorded that plant in its accounts. There is no evidence that Pacific either charged the equipment to expense when it acquired it or originally lumped it in with other continuing property record items.

63. Overland produced no evidence supporting its hypothesis that unrecorded equipment was all charged to expense when acquired or lumped in with other continuing property items.

64. Pacific's practice of "reverse retirement" offers a reasonable accounting treatment for addressing the discover of "unrecorded" plant.

65. Pacific's intrastate net plant is overstated by an average of \$29 million as a result of an error in Pacific Bell's Restructuring Reserve IEMR ratemaking adjustment.

66. To the extent we adopt any of Overland's adjustments to depreciation expense, we should also adjust accumulated reserve for depreciation.

67. Overland found that when Pacific's combined depreciation expense, short-term borrowings, and investment tax credit for a period exceeds its annual construction expenditures, Pacific considers this negative amount as a negative source of externally generated funds. The result is that this negative amount is treated as a use of capital.

68. There is no Commission ruling or order disallowing the methodology Pacific employs to implement the Resolution RF-4 calculations. It is not reasonable to reverse this long-standing methodology.

69. Pacific failed to expense PBOP prefunding contributions.

70. The FCC requires the expensing of PBOP prefunding contributions.

71. Overland's recommendation of a rate base reduction of \$13.3 million of each of the three audit years is reasonable.

72. Cash working capital requirements typically are calculated through a "lead-lag" study, which compares revenue and expense "lags" to calculate the average annual amount of cash working capital associated with a particular expense category.

73. While Pacific has not updated any of its lead-lag studies, used to determine its cash working capital needs, since 1988, there is no evidence that the studies are inaccurate.

74. Pacific appropriately determined its cash working capital requirements pursuant to the Commission's Standard Practice U-16.

75. There are no circumstances that warrant deviation from Standard Practice U-16.

76. Standard Practice U-16 authorizes including "non-cash" items such as depreciation in cash working capital

77. The record is not sufficiently specific on what was in Pacific's start-up rate base.

78. Pacific proposed to an adjustment to cash working capital based on arguments presented in the proceeding.

79. It is reasonable to deduct \$142.2 million in 1997, \$91.3 million in 1998 and \$91.1 million in 1999 from the working capital amounts included in rate base.

80. There is no factual basis to change the current accounting practices applying to directory publishing.

81. The Phase 2A decision deals with audit corrections related to prepaid pension assets.

82. Pacific recorded its FAS 112 liability in Account 4310.

83. Rate base consists of investments made by utility shareholders on which they are entitled to earn a reasonable return.

84. Pacific's FAS 112 liability is a zero-cost source of funds, rather than a shareholder investment.

85. Overland's proposed adjustments to rate base arising from FAS 112 liability issues are reasonable.

86. Vacation pay liability represents cost-free capital to Pacific.

87. Overland's proposed adjustments to rate base arising from vacation pay liability considerations are reasonable.

88. Pacific's FAS 106 liability represents cost-free capital to the company. Overland's proposal to exclude them from rate base is reasonable.

89. Since we have disallowed as unauditable contingent liability accruals, there is nothing to add to rate base.

90. Since we have disallowed contingent liability accruals, it is reasonable to accept Overland's recommended rate base adjustments concerning this matter.

91. Overland reported that it did not find that Pacific's internal controls for affiliate transaction had a material impact on Pacific's CPUC-basis financial results during the years 1997 through 1999.

92. The plain language of the 1997 Consent Decree clearly states which SBC affiliates are obliged to provide time reporting for affiliate transactions.

93. SBC holding company, SBC Services and SBC Operations are not on the list of affiliates that must provide time reports for transactions regarding SBC affiliates.

94. Overland's opinion that the Consent Decree applies to the SBC holding company as well as SBC Operations and SBC Services rests on faulty analysis.

95. Pacific provided evidence adequate to refute Overland's allegation that Pacific's "Image Maker" program demonstrated inadequate internal controls.

96. There is no basis for finding that there are deficiencies in Pacific's tracking of legal matters and no basis for ordering a specific change. It would be reasonable to address changes in the tracking of legal matters in a subsequent NRF proceeding.

97. TRI's research expenses are modest.

98. Telecommunications advances largely stem from research and technological advances.

99. Overland did not conclude that the accounting and internal controls pertaining to affiliate transactions had a material effect on Pacific's earnings.

100. There was no documented dispute between Pacific and the entities charging Pacific management fees.

101. The management fees SBC Services passed on to Pacific rose from \$30 million in 1999 to \$1.1 billion in 2000.

102. SBC uses a general allocator that passes a majority of costs on to the regulated utility. Dollars are driven to the affiliate with the highest investment – the regulated telephone company, which has years and years of built up investment.

103. Most of SBC's cost allocations to the regulated utility were based not on the first principle of Part 64 requiring direct assignment of costs, but rather were

based on a general allocator based on the size of the affiliate's investment. Since the regulated telephone companies have the greatest amount of investment, they bear a large portion of costs.

104. Pacific classified certain expenses to the incorrect Part 32 accounts, but these had no impact on IEMR reported earnings.

105. SBC Operations lost certain documentation supporting the SBC Operations allocation factors for assignment of costs to Pacific Bell.

106. Overland acknowledged that the costs allocated to Pacific from SBC Operations did not have a material impact on Pacific's financial results.

107. Overland concluded that controls used for the charges Pacific assessed on unregulated SBC affiliates "generally functioned to provide the intercompany balance control as intended."

108. Pacific's FMV studies meet the FCC standards for FDC rates it charges its affiliates.

109. Pacific's act of giving the SBC Shared Services organization "access" to its customer database does not constitute a "transfer" of customer records.

110. Pacific did not obtain the Commission's approval to transfer Pacific Bell Directory to Pacific Telesis Group.

111. It is unclear from the facts before us whether the transfer of Pacific Bell Directory, a subsidiary of Pacific Bell, to its common parent, Pacific Telesis, constitutes an ultimate change in control that triggers the provisions of Article 6 of the Public Utilities Code..

112. It is reasonable to require Pacific Bell to file an application seeking that the Commission either determine that Article 6 does not apply to the transfer of Pacific Bell Directory from Pacific Bell to Pacific Telesis, or grant approval of the transaction in the event that Article 6 does apply.

113. Pacific's affiliate ASI is important because it is the entity in which most of Pacific's DSL services are housed.

114. There is currently a very active and growing market for DSL in Pacific's territory, and we can expect DSL to become an even more popular service in the future.

115. The ASI asset transfer proceeding provides an appropriate forum for investigation DSL related issues.

116. Pacific agreed to limit its regulated operations' exposure for Pacific Bell executive compensation to \$200,000 per year per executive.

117. Pacific made a regulatory adjustment on the IEMR for executive compensation during the audit period. Pacific voluntarily reduced intrastate regulated operating expense by \$20 million, \$8 million, and \$7 million in 1997, 1998 and 1999 respectively.

118. SBC made award payments to certain of its key executives in connection with SBC's 1998 investment in AMDOCS, a telecommunications software company, and SBC's merger with Ameritech.

119. During the audit period, the SBC parent organization allocated certain executive compensation to Pacific Bell Directory that exceeded the \$200,000 cap.

120. Pacific Bell Directory bore yet another executive compensation expense in excess of the \$200,000 cap - called "special executive compensation" - based on a general allocator.

121. Pacific also bore the expense of the AMDOCS acquisition/Ameritech merger executive compensation allocated to it by SBC Operations (and not just the parent).

122. Pacific bore executive compensation related to the AMDOCS acquisition/Ameritech merger - this time allocated to it by SBC Services.

123. With regard to SBC's allocation to Pacific of legal fees associated with SBC's work on 1) Constitutional issues regarding the Telecommunications Act of 1996 (1996 Act), 2) Section 271 long distance service applications pursuant to the 1996 Act, and 3) Pacific's participation in the AT&T/Media One merger proceeding, Pacific did not explain the benefit to the regulated utility or demonstrate that the expense directly applied to the utility's regulated activities. It is reasonable to disallow these expenses as proposed by Overland

124. SBC allocated legal expenses to Pacific Bell Directory.

125. As shown in Appendix D hereto, Pacific did not dispute the auditor's non-affiliate-transaction adjustments in connection with items similar to those Pacific disputes related to parent expenses for public relations and corporate sponsorship allocated to Pacific Bell and Pacific Bell Directory.

126. Pacific was charged in 1998 and 1999 when an unregulated affiliate, MSI, conducted market research and investigated potential acquisitions throughout the world. These expenses relate to international lines of business and should not be included in the regulated accounts.

127. During the audit period, Pacific and Pacific Bell Directory bore expense related to the SBC parent's strategic planning activities.

128. Pacific failed to demonstrate that SBC parent's strategic planning activities benefited Pacific.

129. The SBC parent company billed Pacific \$7.4 million in 1998 for services rendered in 1997. It is reasonable to adopt Overland's recommended adjustment.

130. Pacific properly recorded inter-company revenue associated with marketing services provided to affiliates.

131. Pacific claimed that regulated operations were directly billed for only 3.5% of the SBC National-Local IT costs associated with Pacific's effort to expand service into 30 metropolitan areas outside of Pacific's service area. This claim is inconsistent with its discovery response to Overland in which it claimed that Pacific was billed for this work according to a general allocator because Pacific's effort to expand into metropolitan areas outside Pacific's service territory "was thought to benefit the company as a whole rather than a specific regulated or nonregulated area."

132. In 1997, Pacific recorded a portion of the payment it made for the naming rights to Pacific Bell Park above-the-line, which is not appropriate for goodwill advertising.

133. Pacific corrected depreciation expense allocation in December 1999 consisted with its Cost Allocation Manual. This allocation is reasonable and consistent with Commission policy.

134. Pacific allocated its product advertising expense consistent with the Cost Allocation Manual. This allocation is reasonable and consistent with Commission policy.

135. Pacific concedes that audit adjustments for political and legislative influence and regulatory affairs are appropriate when the regulated utility carries out the activities.

136. It is reasonable to exclude external relations costs in account 6722 that were assigned to regulated operations.

137. During the audit period, Pacific Bell tracked expenses it incurred in marketing telephone services in GTE's (now Verizon's) service territory. Such expenses should not be included in regulated operations.

138. Costs associated with applying for interLATA service were properly charged to regulated operating income.

139. Pacific performs fluctuation analyses to show changes from month to month in the assignment of costs to regulated and nonregulated categories. Overland found Pacific's documentation lacking in several respects and recommended that the Commission order Pacific to document its results to provide an adequate audit trail.

140. Pacific's response did not show that its fluctuation analyses provided adequate detail or explained what products or marketing initiatives were causing the resulting monthly fluctuations.

141. Pacific's Commission Cost Allocation Manual (C-CAM) is not up-to-date and certain descriptive information is missing. Responsible Pacific staff acknowledged the need to update the C-CAM.

142. Pacific does not maintain an audit trail translating the trial balances of its individual subsidiaries to Pacific's FR book (the books it uses to derive the IEMR report). Pacific reports the overall financial results of its PBIS and PBNI subsidiaries in the FR books, but does not maintain detail about how it translates the subsidiaries' trial balances to the FR books.

143. PBIS and PBNI have a significant financial impact on Pacific's business. Therefore, we believe the financial data regarding these subsidiaries' impact on the IEMR should appear in detail so that we have the opportunity to determine how Pacific calculates its IEMR results. Accordingly, we adopt the audit recommendation and require Pacific to make a compliance filing within 60 days of the effective date of this decision detailing how it will make more transparent and auditable the process it uses for translating PBIS' and PBNI's financial trial balances to its FR books and IEMR reports.

144. Pacific uses its ESTRS system as a statistically valid sampling process to determine the allocation of marketing hours between regulated and nonregulated work activities.

145. Pacific's PBNI personnel hours are reported to a nonregulated tracking code, and there is no need to include them in the ESTRS process.

146. Overland methodology for determining Pacific's response times to data requests unfairly suggests that Pacific impeded the audit.

147. Pacific's exercise of its right to object to data requests based on privilege, scope and/or relevance was proper and consistent with Commission procedures.

148. Overland did not conclude that Pacific "impeded" the audit.

149. The record does not establish that Pacific impeded the audit.

150. Overland propounded over 1,300 data requests, with 1,000 devoted to Phase 2B issues. Many of the data requests included multiple subparts.

151. ALJ Resolution 164 recognizes the right to object to a discovery request and establishes a procedure for resolving these requests.

152. The Commission failed to resolve Pacific's objection to a discovery request during the audit period.

153. The Commission's distribution of the wrong version of D.00-02-047 precipitated disputes concerning the scope of the audit.

154. The correction version of D.00-02-047 in fact limited the scope of the audit.

155. Pacific properly exercised its right to object to discovery requests consistent with D.00-02-047 and Commission procedures.

156. While there are small differences among the various ORA proposals, we find that for the most part, ORA recommends that Pacific correct the errors in its

IEMR reports and pay an additional 18 percent as either interest or an “incentive” to ensure proper performance in the future.

157. Many of the changes we order to the 1997-99 IEMR reports also apply to subsequent years.

158. It is reasonable to make the audit adjustments as described herein.

159. It is reasonable for Pacific to recalculate earnings for 1997 and 1998 based on the audit corrections ordered herein.

160. Several of the changes we make here do not relate to one-time events that will not recur. Rather, we order many changes in the way Pacific keeps its books and reports its revenues and expenses on an ongoing basis.

161. The 90-day commercial paper rate currently stands in the 2 percent range.

162. Commission policy is to calculate interest on shareable earnings at the 90-day commercial paper rate.

163. It is reasonable to use tariff surcredits consistent with the procedure adopted in D.89-10-031 to distribute any shareable earnings or refunds resulting from this decision and the Phase 2A decision.

164. It is not reasonable to develop a regulatory incentive program that applies to accounting practices.

165. It is not reasonable to order the sharing of earnings in 1999.

166. It is not reasonable to impose an 18 percent penalty on under reported earnings.

167. ORA’s expert did not recommend further audits of the years 1997-1999.

168. The audit did not conclude that affiliate transactions materially affected earnings.

169. A further audit of transactions from 1997 through 1999 is not reasonable.

170. At some point the total audit costs will be ascertainable with reasonable certainty and minimal controversy. It is premature to decide whether and how to recover these costs at this time.

Conclusions of Law

1. It does not violate GAAP to require Pacific to make changes to its IEMR for Commission regulatory purposes the year in which we find Pacific made an error in its reporting, rather than in the year the error was discovered.

2. The Commission requires accurate IEMR reporting for many reasons, including:

- To ascertain whether exogenous or limited exogenous factor cost recovery treatment is appropriate and, if so, the amount by which rates should change.
- To decide when individual service rate increases are justified.
- To resolve whether recategorization requests (to move services among the three NRF service categories) should be approved.
- For purposes of universal service proceedings.
- For regulating rates for Category I, such as unbundled network elements.
- To monitor the financial impact of regulation

3. In combination, the audit corrections Overland identified and adopted herein were sufficiently “material” to require the changes in Pacific’s reporting that we order in this decision.

4. Overland’s staff was qualified to perform the audit.

5. We disallow as unauditable Pacific’s contingent liability accruals, and required Pacific to account for its contingent liabilities on an as-paid basis.

6. In the context of its contingent liability claims, Pacific did not place the reasonableness of its lawyers’ advice at issue in this proceeding.

7. There was no implied waiver of the attorney-client privilege by Pacific.

8. Pacific did provide over 4,900 non-privileged documents to support its contingent liability accruals.

9. Pacific's valid objection to disclosing other privileged documents made it impossible for Overland to carry out the audit in accordance with GAAS.

10. Pacific's contingent liability accruals were not justified for purposes of this proceeding and should be reduced in accordance with the audit recommendation to reflect the amounts Pacific actually paid in relation to the accrued claims.

11. The FCC only allows utilities to account for contingent liability claims on an as-paid basis.

12. Pacific should have posted accruals in 1996 for estimated bad debts resulting from its RCRMS system.

13. The audit does not show that Pacific improperly accounted in 1997 for a change in how it accounts for revenues and expenses resulting from published directories.

14. Pacific should not have deferred LNP costs as a regulatory asset on its IEMR books as of April 1996. The requirements of SFAS 71 were not satisfied.

15. As of May 1998, when the FCC issued its Third Report and Order, Pacific should have recovered all of the expense related to LNP exclusively in the federal jurisdiction.

16. D.96-03-020, D.97-04-083 and D.98-11-066 did not provide Pacific adequate assurance of cost recovery for local competition implementation costs to support the creation of a regulatory asset.

17. Pacific properly accounted for its SBC-Pacific merger savings, with the exception of \$4.2 million in conceded adjustments for both 1998 and 1999.

18. Pacific's 1999 change to the Lucent software right-to-use contract was properly recorded as an expense.

19. We reject as unreasonable Overland's recommended adjustment for the year 1999 related to Pacific's software right-to-use contract with Lucent.

20. Because GAAP does not preclude retroactive changes to the IEMR books, Pacific's incentive pay cost accruals should be changed to reflect actual payout amounts.

21. We adopt no change based on the audit report in how Pacific accounted for \$30 million in what Overland called a "royalty fee."

22. Pacific should not have made a \$12.6 million entry related to pre-1976 disabilities that Pacific's actuaries had not previously valued in 1997. This expense should be written off or charged below-the-line in a way that does not affect ratepayers.

23. Pacific should be required to provide stand-alone actuarial reports for the Pacific Bell component of SBC benefit plans.

24. Since Pacific lacked depreciation freedom prior to 1997, it was reasonable to correct its IEMR depreciation error in 1997, the year in which it discovered the error and a year in which the Commission granted Pacific depreciation freedom.

25. Pacific's accumulated deferred income taxes (ADIT) should be given flow-through tax treatment in accordance with our Decision in Phase 2A.

26. Pacific should have reversed out its sales and use tax accruals in the period in which it originally recorded them, rather than in later periods.

27. Pacific should have corrected its error of failing to generate accruals for the employer's portion of payroll taxes, made when it processed certain manual paychecks, in 1998 and prior periods, rather than making a catch-up accrual in 1999. To do so would not have violated GAAP.

28. Pacific should adjust the IEMRs for 1998 and 1999, the affected years, in response to the audit finding that it overstated its intrastate regulated deferred income tax expenses, rather than correcting the error in 2000.

29. Pacific should account for the Ameritech severance accrual and the associated income tax effects on a consistent basis, below-the-line. Pacific should restate its 1999 Commission books to remove the current period and deferred income tax effects associated from the severance accrual from its above-the-line accounts.

30. Pacific's "reverse retirement" procedure is a reasonable response to the audit finding of equipment not recorded in company accounts.

31. It is reasonable to adopt Overland's proposed adjustment to intrastate net plan.

32. Pacific should adjust its IEMRs to reflect adjustments for accumulated reserve for depreciation for any audit adjustment we adopt related to Pacific's depreciation expense.

33. Pacific's calculation of its AFUDC complies with the method adopted for Pacific in Resolution RF-4.

34. Pacific should use the FCC's AFUDC rate beginning with the year 2003.

35. Pacific should have expensed PBOP pre-funding contributions made prior to the adoption of FAS 106 in accordance with Overland's audit recommendation and our decision in Phase 2A decision of this proceeding.

36. The procedures set forth in Standard Practice U-16 guides the calculation of "cash working capital." The Commission, however, may find that "special circumstances" exist to deviate from Standard Practice U-16.

37. The TURN/ORR proposal to set Pacific's working capital figure at zero is unreasonable because it removes cash working capital from rate base on the basis of alleged errors or complexities in the calculation.

38. Since we find no "special circumstances" that justify a deviation from Standard Practice U-16, it is reasonable to adopt only the rate base changes concerning cash working capital proposed by Pacific and described herein.

39. Pacific's accounting for prepaid directory expense is reasonable.

40. The FCC requires amounts in account 4310 to be removed from interstate rate base.

41. Although FCC accounting methodology is not controlling for our purposes, the Commission often looks to the FCC for guidance.

42. Since there is no controlling precedent of this Commission on the treatment of FAS 112 liabilities, we find it appropriate to follow the FCC's guidance and exclude the liabilities from rate base.

43. Accrued vacation pay liability should not form part of the rate base that is used to determine Pacific's ROR and sharable earnings.

44. Our Phase 2A decision finds that ratepayers were not liable in 1999 and subsequent years for FAS 106 costs that Pacific chose not to fund. These unfunded accruals should be removed from rate base. These accruals should not be included in rate base that is used to determine Pacific's ROR and sharable earnings.

45. Because we disallow as unauditable Pacific's contingent liability accruals, there is nothing to add to rate base. These accruals should not be included in rate base on which Pacific is allowed a return.

46. The work Pacific has done thus far to enhance its internal controls is adequate to ensure compliance with our rules.

47. The FCC 1997's Consent Decree required employees of certain SBC parent organizations to keep time records for affiliate transactions.

48. The Consent Decree does not .

49. Pacific showed that its "Image Maker" has adequate internal controls at Pacific.

50. Allocating most of TRI's modest research expenses to the regulated utility is reasonable. .

51. Pacific has a responsibility to protect its own ratepayers by ensuring that its parent and affiliate organizations only pass costs onto the regulated utility that the utility should bear pursuant to cost causative principles.

52. FCC Part 64 guidelines establish the hierarchy of cost allocation. The first principle of such assignment is that "costs shall be directly assigned to either regulated or nonregulated activities whenever possible." Part 64 only allows reliance on a general allocator after all other, more specific methods of allocation have been tried.

53. There is no requirement that Pacific charge a 10% mark-up to regulated affiliates.

54. Pacific Bell Directory's FMV studies meet the FCC standard of charging FMV to affiliates for services.

55. There is no evidence that Pacific's practices concerning charges to non-regulated affiliates fail to comply with Commission rules.

56. Pacific Bell should have obtained a Commission decision concerning the applicability of Cal. Pub. Util. Code § 851 et seq. to its transfer Pacific Bell Directory to its then-parent, Pacific Telesis Group.

57. The ASI asset transfer proceeding would be a better docket in which to determine whether ratepayers are entitled to compensation for DSL development costs, and therefore defer this issue to that docket.

58. It was appropriate for Pacific to book on January 1, 2000 \$47 million in transfer fee revenue related to Pacific's transfer of 2,935 employees to SBC Services in December 1999.

59. Pacific's regulated operations should not bear the expense of executive compensation over \$200,000 per year if the executives work for affiliates of Pacific Bell, rather than for Pacific Bell itself.

60. To the extent that Pacific bears the cost of general "management fees" allocated from SBC to Pacific's regulated operations show double charges management. Once for excess executive salaries, and a second time for the cost of executives rolled into the management fee.

61. The Commission's affiliate transaction rules and the FCC's Part 64 regulations require that there be some benefit associated with an allocated cost. Pacific showed no such benefit for its excess executive compensation costs.

62. For the audit period, SBC entities' executive compensation recorded for regulatory purposes should be capped at \$200,000 per year per executive, regardless of where those executives are employed.

63. The award payments SBC made to certain of its key executives in connection with SBC's 1998 investment in AMDOCS, a telecommunications software company, and SBC's merger with Ameritech exceeded the threshold for executive pay and should not be included in regulated expenses.

64. The SBC parent organization should not have allocated any executive compensation to Pacific Bell Directory that exceeded the \$200,000 cap.

65. Pacific should not have borne the expense of the AMDOCS acquisition/Ameritech merger executive compensation allocated to it by SBC Operations (and not just the parent) in excess of the \$200,000 cap.

66. Pacific should not have borne executive compensation in excess of \$200,000 related to the AMDOCS acquisition/Ameritech merger allocated to it by SBC Services or SBC operations. Such compensation had no direct or obvious benefit for Pacific's regulated operations.

67. Pacific's regulated operations should not have borne any of the executive award payments because they exceeded the \$200,000 threshold for executive pay. Such compensation had no direct or obvious benefit for Pacific's regulated operations.

68. SBC improperly allocated to Pacific legal fees associated with SBC's work on 1) Constitutional issues regarding the Telecommunications Act of 1996 (1996 Act), 2) Section 271 long distance service applications pursuant to the 1996 Act, and 3) Pacific's participation in the AT&T/Media One merger proceeding.

69. Pacific did not demonstrate how the legal expenses the parent operation billed to Pacific Bell Directory benefited Directory, and we should disallow those expenses.

70. Since Pacific's regulated operations should not bear the cost of image advertising, then it follows that Pacific should not bear the cost of such advertising carried out by an unregulated parent or affiliate of Pacific, as occurred here.

71. It would create improper incentives to allow SBC to charge to Pacific's regulated operations certain expenses that would not be allowable above-the-line if Pacific itself incurred them.

72. Ratepayers should not even indirectly support the costs of Pacific's image building efforts and public relations expense.

73. The Commission has disallowed having regulated operations bear the cost of image advertising under NRF.

74. MSI's market research and investigation of potential acquisitions throughout the world do not benefit Pacific. If the allocation does not otherwise benefit Pacific, such benefit does not occur simply because in the future Pacific's share of the allocation will lessen as SBC grows bigger.

75. Pacific did not show that the SBC parent's strategic planning activities benefit the regulated utility. Without such justification, it is improper for the utility to bear the expense. Such activities create potentially anti-competitive cross subsidies.

76. Because GAAP does not govern the IEMR, it did not preclude the SBC parent company from billing Pacific \$7.4 million in 1997 for services rendered in that year, rather than in 1998.

77. Any cross-subsidy flowing from Pacific's regulated operations to its National-Local competitive local exchange affiliate would be anticompetitive, as unaffiliated competitive local exchange carriers receive no such subsidy.

78. Pacific's regulated operations should not have borne any expense related to Pacific's National-Local affiliate.

79. In D.01-06-077, we stated that "[t]he Commission does not allow recovery from ratepayers of institutional or goodwill advertising.

80. Pacific should not have recorded expense related to its sponsorship of Pacific Bell Park, a baseball stadium, above-the-line.

81. Pacific made an erroneous correction to the December 1999 allocation of depreciation expense, resulting in an understatement of nonregulated depreciation expense.

82. Pacific followed Commission policy in allocating correcting entries using the December 1999 cost allocation ratios for depreciation expenses.

83. Pacific allocated its Product Advertising Expense in accordance with the Cost Allocation Manual.

84. The majority of the external relations costs in Pacific's account number 6722 were improperly assigned directly to regulated operations.

85. In D.94-06-011, the Commission found that Pacific should continue to record dues, donations and political advocacy expenses below-the-line.

86. Pacific's regulated operations should not be charged differently depending upon which entity engages in the legislative and regulatory activities.

87. California regulated operations should not bear the expense of political and legislative influence activities and other external relations expenses.

88. Pacific should not reflect costs related to marketing telephone services in GTE's (now Verizon's) service territory in its regulated operations, recover the costs from its regulated customers in Pacific's service territory, or reflect the costs in the earnings of the regulated entity.

89. Because PBIS and PBNI have a significant financial impact on Pacific's business, the financial data regarding these subsidiaries' impact on the IEMR should appear in detail so that we have the opportunity to determine how Pacific calculates its IEMR results.

90. If all of the PBNI personnel's hours are reported to a nonregulated tracking code, there is no need to include them in Pacific's ESTRS process. We decline to take any action on the audit recommendation in this regard.

91. The data requests of Commission staff or its agents are deemed presumptively valid, relevant and material. However, a utility may timely object to such data requests consistent with the procedures outlined in ALJ Resolution 164.

92. In conjunction with a Commission proceeding, a utility should be penalized for asserting its rights under ALJ Resolution 164.

93. Pacific's earnings did not exceed the sharing threshold in 1997, in accordance with the findings of this decision combined with our findings in the Phase 2A decision.

94. Pacific's earnings did not exceed the sharing threshold in 1998, in accordance with the findings of this decision combined with our findings in the Phase 2A decision.

95. Even where the changes we order in this decision do not cause Pacific to share earnings, the integrity of its books and records, and the regulatory process, must be preserved. Therefore, we should order Pacific to make each of the changes we discuss in this decision.

96. Pacific should be required to change its IEMRs for 2000 forward and continuing until otherwise specified by the Commission. If we were to limit the required changes to the IEMRs issued during the audit period, regulatory accounting that we have already found to be in error would continue into the future.

97. To the extent the changes we order affect Pacific's ongoing reporting for 2001 forward, it would hurt ratepayers and the regulatory process for us to allow Pacific to continue disallowed practices. We should require Pacific to amend its IEMRs and other processes to demonstrate that it is not continuing the practices that we find objectionable or improper in this decision.

98. Pacific should recalculate earnings for 1997, 1998, and 1999 based on the audit corrections we order it to make here. If we simply reverse the incorrect expense and revenue assumptions the audit reveals in the current year, ratepayers will not be made whole.

99. In D.01-06-077, the Commission ordered Roseville Telephone Company to share earnings retroactively and pay interest based on the amount ordered in D.89-10-031, which was the 90-day rate.

100. We decline to impose the 18 percent interest rate requested by ORA. We believe that the 90-day commercial paper rate is appropriate and consistent with Commission precedent.

101. Requiring Pacific to record the refund of sharable earnings and other refunds and the associated interest below-the-line is consistent with the Commission's treatment of shareable earnings in D.89-10-031, in which the Commission stated that a "ratemaking adjustment may be required in a year in which a prior year's excess earnings are returned to ratepayers through the sharing mechanism, to prevent the return of earnings from depressing current year earnings in the sharing calculation." Shareable earnings in a prior year should not distort reported earnings in a subsequent year.

102. Requiring Pacific to reflect the sharable earnings surcredit in Rule 33 of its tariffs is consistent with the procedure adopted in D.89-10-031 for returning shareable earnings to end-users. In that decision, the Commission required that shareable earnings should be made through a bill and keep surcredit to all Category I basic monopoly services, excluding switched and low speed special access and other services normally excluded from surcredits.

103. The surcredit process we adopt in this decision will return any sharable earnings to end-users in a practical, fair, and equitable manner.

104. While there have been substantial recategorization of services from Category I since the Commission rendered its decision in D.89-10-031, the rationale of flowing shareable earnings and applicable interest to end users is the same today as it was previously.

105. Only end-user customers – and not purchasers of intermediary services such access services and UNEs – should receive the benefits of the surcredit.

106. We do not find that the Commission should not have suspended sharing in 1999. To do so would require a reexamination of the entire record leading up to D.98-10-026, our decision suspending sharing, to determine the full basis for the Commission's decision and the evidence it had before it. Nor can we state with any certainty that the Commission would have done anything differently had it had the benefit of the Overland audit.

107. Under the sharing mechanism, ratepayers share only in earnings above a certain threshold. Ratepayers by definition receive no amount of earnings below the threshold.

108. We do not have an adequate basis in the record currently before us to conclude that Pacific committed fraud in underreporting its earnings or convincing the Commission to suspend sharing in 1999.

109. We do not have a record before us to justify imposing a penalty on Pacific pursuant to Pub. Util. Code § 798, which allows us to impose civil penalties on carriers that willfully make imprudent payments to or receive less than reasonable payments from subsidiaries, affiliates or holding companies.

110. The Commission needs to find effective ways to deter Pacific from underreporting earnings and overreporting expenses if the Commission is to obtain the accurate financial information it needs.

111. We do not have an adequate record on the types of incentives we might impose in this context.

112. We do not have an adequate record to determine whether the Commission should reinstitute ratepayer sharing.

113. Audits are an essential part of NRF. They provide a means for the Commission to monitor utility financial performance, to determine if utilities are complying with Commission rules and statutory requirements, and to assess whether the Commission's goals for NRF are being met.

114. Even if no problems are found pursuant to an audit, it is prudent for the Commission to maintain continuous, comprehensive, and vigilant oversight of large utilities like Pacific that provide essential services to millions of Californians.

115. ORA asks us to institute a penalty phase to determine whether Pacific violated the affiliate transaction rules and Pub. Util. Code § 2891 regarding disclosure of residential customers' information, and, if so, whether to order penalties or other relief. It is premature to decide whether a penalty phase is warranted on Pacific's affiliate transactions compliance until the auditors complete the affiliate transactions review for 1997-99. ORA may renew its request after that audit is completed.

116. Granting access of SBC Operations to Pacific's customer information was consistent with current rules.

117. The Commission noted in D.96-05-036, addressing Pacific's effort to transfer audit responsibility away from DRA, ORA's predecessor, that, "In its petition [to modify D.94-06-011, which prescribed the audit], Pacific sought to have the audit performed under the supervision of the Commission's Advisory

and Compliance Division (CACD) [TD's predecessor]. Pacific Bell also indicated its willingness to fund the CACD supervised audit.

118. At some point the total audit costs will be ascertainable with reasonable certainty and minimal controversy.

119. It is premature to determine whether we should disallow some or all of the audit costs.

O R D E R

IT IS ORDERED that:

1. Pacific Bell, now known as SBC (Pacific), shall prepare schedules that identify each of this decision's adopted adjustments and demonstrate that Pacific has properly reflected the ordered adjustments in its financial reporting. Pacific shall file the schedules, along with supporting documentation, as a compliance Advice Letter filing due no later than 90 days after the effective date of this decision.

2. Pacific shall update its Intrastate Earnings Monitoring Reports (IEMRs) reports no later than 90 days following the effective date of this decision, submit the updated reports as a compliance filing in this proceeding, and also file them in the manner it files its other IEMR reports as they come due.

3. Pacific shall correct its IEMRs for years subsequent to 1999 consistent with the adjustments that we require for the 1997 – 1999 reports. Pacific shall file the correct reports no later than 90 days following the effective date of this decision in the manner it files its other IEMR reports as they come due, and also submit the updated IEMRs as a compliance filing in this proceeding.

4. Pacific shall implement a surcredit to refund any sharable earnings or refunds that result from the Commission's decision issued in Phases 2A and 2B

of this proceeding. The amount of sharable earnings and refunds is set forth the Phase 2A decision.

5. Pacific shall implement the surcredit we order herein for a 12-month period and apply the surcredit uniformly across local exchange services and residential intraLATA toll services, in accordance with Pacific tariff Rule 33. The surcredit shall commence no later than 120 days from the effective date of this decision. The surcredit shall not apply to Intermediary Services such as access services and unbundled network elements.

6. Regardless of the category that the above services reside in, Pacific shall follow the procedure adopted in D.89-10-031 to return to ratepayers the shareable earnings adopted in this decision and the Phase 2A decision.

7. Pacific shall make a compliance filing within 90 days of the effective date of this decision listing each finding from this decision that has ongoing effects for its record-keeping, reporting or other activities, declaring under oath that it is no longer engaged in disallowed practices, and demonstrating that its practices for 2001 forward comply with this decision.

8. We will consider a renewed request for exogenous treatment of the full amount of audit costs. We defer ruling on Pacific's request for exogenous cost recovery of the audit costs until this decision is final.

9. Pacific Bell shall file an application seeking a Commission determination of the applicability of sections of Article 6 of the Pub. Util. Code and/or seeking Commission approval pursuant to Article 6 for the transfer of Directory Services to Pacific Telesis no later than 90 days following the effective date of this decision. This filing shall also comply with all of the requirements of D.85-12-065.

10. We defer to the ASI transfer proceeding, Application 02-07-039, the determination of whether ratepayers are entitled to compensation for DSL development costs.

11. In its compliance filing due 90 days after the effective date of this decision, Pacific shall address the audit's assertions regarding whether Pacific's California Cost Allocation Manual is up-to-date, including those related to the information Overland obtained from staff. Overland states that responsible Pacific staff acknowledged the need to update the C-CAM. Pacific's staff also identified certain listings in the CAM that required updating, although Overland found the listings the staff identified to be inadequate. Further, Overland claims Pacific's staff told its auditors that certain aspects of the C-CAM had not been updated since 1996. We will then address the issue in Phase 3B of this proceeding.

12. Pacific shall make a compliance filing within 90 days of the effective date of this decision detailing how it will make more transparent and auditable the process it uses for translating PBIS' and PBNI's financial trial balances to its FR books and IEMR reports. Pacific shall also implement its proposed course of action, with any change(s) the Commission orders.

13. Pacific shall correct the IEMR reports for 1997, 1998 and 1999 to reflect all of the audit adjustments adopted by the Commission in Phases 2A and 2B.

14. Pacific shall pay the 90-day commercial paper rate as interest on top of the amount it shares in earnings for 1997 and 1998.

15. Pacific shall record the sharable earnings refund and associated interest it is required to pay as a result of this decision and the Phase 2A decision below-the-line.

16. We deny ORA's request for an order requiring Pacific to refund the earnings that would have been shareable had the Commission not suspended sharing in 1999.

17. If Pacific received any rate increases or had any rate floor changed as result of its reported 1999 IEMR results, or based any such request in whole or part on such results, it shall call those to our attention in its compliance filing due 90 days after the effective date of this decision. Any party may comment on that filing with 30 days, and suggest remedies and identify other possible effects of Pacific's incorrect reporting. Pacific shall also include the same information for 1997 and 1998 in its filing.

18. We deny ORA's request for an order requiring Pacific to refund 18 percent of all underreported earnings for the audit years, regardless of whether earnings met the sharing threshold for 1997-98, and regardless of the Commission's suspension of sharing in 1999.

19. We deny ORA's request to lift the suspension of sharing and establish a memorandum account to track excess earnings subject to refund.

20. We decline ORA's request to impose a \$20 million annual payment on Pacific as an incentive for Pacific to cooperate with the completion of the 1997-99 affiliate transaction audit and the carrying out of the 2000-02 audit, until it deems Pacific to be cooperating fully with both audits.

21. We deny ORA's request for an order instituting a penalty phase to determine whether Pacific violated the affiliate transaction rules and Public Utilities Code § 2891 regarding disclosure of residential customers' information, and, if so, whether to order penalties or other relief.

22. We decline to conduct a further audit of the 1997-1999 books of Pacific and its affiliates.

23. We defer to Phase 3B ORA's request to revise the Commission's NRF monitoring report program. This order is effective today.

Dated _____, at San Francisco, California.

APPENDIX A

APPENDIX B

R.01-09-001 / I.01-09-002

**Joint Exhibit of Overland Consulting, Inc., ORA, TURN and Pacific Bell
Showing Impact of Audit Corrections on Pacific Bell's Reported IEMR Results for 1997 - 1999**

Index #	Report Chapter	Adjustment Description (A) (B)	Status of Dispute	Party	NOTES	1997 Final Adjustments	1997 Individual Adjustment Impact on Rate of Return	1998 Final Adjustments	1998 Individual Adjustment Impact on Rate of Return	1999 Final Adjustments	1999 Individual Adjustment Impact on Rate of Return	Total Audit Period Final Adjustment Amounts
		Income Statement Adjustments										
1	5-13	Unsupported Contingent Liabilities - Revenues (IS)	SUBS	Overland		40,463,493	0.40%	0	0.00%	0	0.00%	40,463,493
				ORA	(4)	40,463,493	0.40%	0	0.00%	0	0.00%	40,463,493
				TURN	(5)	40,463,493	0.40%	0	0.00%	0	0.00%	40,463,493
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
2	5-14	Bellcore Dividends (IS)	NONE	Overland		3,883,507	0.04%	0	0.00%	0	0.00%	3,883,507
				ORA	(2)	3,883,507	0.04%	0	0.00%	0	0.00%	3,883,507
				TURN	(6)							
				Pacific		3,883,507	0.04%	0	0.00%	0	0.00%	3,883,507
3	5-15	Uncollectible Revenues - RCRMS (PacBell flows through) (IS)	SUBS	Overland		53,533,000	0.53%	0	0.00%	0	0.00%	53,533,000
				ORA	(4)	53,533,000	0.53%	0	0.00%	0	0.00%	53,533,000
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
4	5-19	Gain on Sale of Bellcore (IS)	NONE	Overland		9,122,587	0.09%	0	0.00%	0	0.00%	9,122,587
				ORA	(2)	9,122,587	0.09%	0	0.00%	0	0.00%	9,122,587
				TURN	(6)							
				Pacific	(8)	9,122,587		0	0.00%	0	0.00%	9,122,587
5	6-15	Local Number Portability Costs (IS)	BOTH	Overland		51,313,964	0.51%	27,904,486	0.27%	22,306,761	0.22%	101,525,211
	S6-1			ORA	(4)	51,313,964	0.51%	27,904,486	0.27%	22,306,761	0.22%	101,525,211
				TURN	(5)	51,313,964	0.51%	27,904,486	0.27%	22,306,761	0.22%	101,525,211
				Pacific		0	0.00%	15,645,112	0.15%	22,306,761	0.22%	37,951,873
6	6-19	Local Competition Costs (IS)	SUBS	Overland		40,974,049	0.41%	7,963,946	0.08%	0	0.00%	48,937,995

R.01-09-001 / I.01-09-002
Joint Exhibit of Overland Consulting, Inc., ORA, TURN and Pacific Bell
Showing Impact of Audit Corrections on Pacific Bell's Reported IEMR Results for 1997 - 1999

Index #	Report Chapter	Adjustment Description (A) (B)	Status of Dispute	Party	NOTES	1997 Final Adjustments	1997 Individual Adjustment Impact on Rate of Return	1998 Final Adjustments	1998 Individual Adjustment Impact on Rate of Return	1999 Final Adjustments	1999 Individual Adjustment Impact on Rate of Return	Total Audit Period Final Adjustment Amounts
				ORA	(4)	40,974,049	0.41%	7,963,946	0.08%	0	0.00%	48,937,995
				TURN	(5)	40,974,049	0.41%	7,963,946	0.08%	0	0.00%	48,937,995
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
7	6-22	Merger Savings Allocation (IS)	AMT	Overland		5,327,527	0.05%	23,321,782	0.23%	(7,704,205)	-0.08%	20,945,104
				ORA	(3)	0	0.00%	2,500,000	0.02%	2,470,000	0.02%	4,970,000
				TURN	(6)							
				Pacific		0	0.00%	2,495,834	0.02%	2,470,279	0.02%	4,966,113
8	6-27	Advanced Communications Network (IS)	NONE	Overland		17,846,219	0.18%	4,284,040	0.04%	2,226,486	0.02%	24,356,745
				ORA	(4)	17,846,219	0.18%	4,284,040	0.04%	2,226,486	0.02%	24,356,745
				TURN	(6)							
				Pacific	(8)	17,846,219		4,284,040		2,226,486		24,356,745
9	6-31	Software Buy-Out Agreement (IS)	SUBS	Overland		0	0.00%	0	0.00%	44,465,490	0.45%	44,465,490
				ORA	(2)	0	0.00%	0	0.00%	44,465,490	0.45%	44,465,490
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
10	6-32	Unsupported Contingent Liabilities - Operating Expense (IS)	SUBS	Overland		89,166,316	0.89%	1,913,966	0.02%	11,765,136	0.12%	102,845,418
				ORA	(4)	89,166,316	0.89%	1,913,966	0.02%	11,765,136	0.12%	102,845,418
				TURN	(5)	89,166,316	0.89%	1,913,966	0.02%	11,765,136	0.12%	102,845,418
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
11	6-34	Incentive Pay Accrual (IS)	SUBS	Overland		34,353,665	0.34%	(40,739,899)	-0.40%	35,061,088	0.35%	28,674,854
				ORA	(2)	34,353,665	0.34%	(40,739,899)	-0.40%	35,061,088	0.35%	28,674,854

R.01-09-001 / I.01-09-002

Joint Exhibit of Overland Consulting, Inc., ORA, TURN and Pacific Bell
Showing Impact of Audit Corrections on Pacific Bell's Reported IEMR Results for 1997 - 1999

Index #	Report Chapter	Adjustment Description (A) (B)	Status of Dispute	Party	NOTES	1997 Final Adjustments	1997 Individual Adjustment Impact on Rate of Return	1998 Final Adjustments	1998 Individual Adjustment Impact on Rate of Return	1999 Final Adjustments	1999 Individual Adjustment Impact on Rate of Return	Total Audit Period Final Adjustment Amounts
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
12	6-37	ISP-Bound Traffic Separations (IS)	NONE	Overland		(11,329,359)	-0.11%	0	0.00%	0	0.00%	(11,329,359)
				ORA	(2)	(11,329,359)	-0.11%	0	0.00%	0	0.00%	(11,329,359)
				TURN	(6)							
				Pacific		(11,329,359)	-0.11%	0	0.00%	0	0.00%	(11,329,359)
13	6-36	Uncollectible Settlements - RCRMS (IS)	SUBS	Overland		28,038,790	0.28%	13,180,440	0.13%	863,874	0.01%	42,083,104
				ORA	(4)	28,038,790	0.28%	13,180,440	0.13%	863,874	0.01%	42,083,104
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
14	7-9	Pension Expense (IS)	SUBS	Overland		105,280,092	1.05%	108,774,347	1.07%	110,496,463	1.11%	324,550,902
	S7-13			ORA	(4)	105,280,092	1.05%	108,774,347	1.07%	110,496,463	1.11%	324,550,902
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
15a	7-13	SFAS 106 (IS)	SUBS	Overland		29,706,000	0.30%	395,443,000	3.89%	103,470,000	1.04%	528,619,000
				ORA	(4)	29,706,000	0.30%	395,443,000	3.89%	103,470,000	1.04%	528,619,000
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
15b	7-13	SFAS 106 - Pension Trust Withdrawal (IS)	SUBS	Overland		0	0.00%	0	0.00%	68,749,000	0.69%	68,749,000
	S7-6			ORA	(4)	0	0.00%	0	0.00%	68,749,000	0.69%	68,749,000
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
16	7-33	SFAS 112 (IS)	SUBS	Overland		9,594,151	0.10%	0	0.00%	0	0.00%	9,594,151
				ORA	(2)	9,594,151	0.10%	0	0.00%	0	0.00%	9,594,151

R.01-09-001 / I.01-09-002
Joint Exhibit of Overland Consulting, Inc., ORA, TURN and Pacific Bell
Showing Impact of Audit Corrections on Pacific Bell's Reported IEMR Results for 1997 - 1999

Index #	Report Chapter	Adjustment Description (A) (B)	Status of Dispute	Party	NOTES	1997 Final Adjustments	1997 Individual Adjustment Impact on Rate of Return	1998 Final Adjustments	1998 Individual Adjustment Impact on Rate of Return	1999 Final Adjustments	1999 Individual Adjustment Impact on Rate of Return	Total Audit Period Final Adjustment Amounts
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
17	8-6	Intrabuilding Cable Amortization (IS)	SUBS	Overland		19,473,832	0.19%	16,611,028	0.16%	0	0.00%	36,084,860
				ORA	(4)	19,473,832	0.19%	16,611,028	0.16%	0	0.00%	36,084,860
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
18	8-7	SAVR Delayed Retirements (IS)	SUBS	Overland		5,906,945	0.06%	4,236,207	0.04%	0	0.00%	10,143,152
				ORA	(2)	5,906,945	0.06%	4,236,207	0.04%	0	0.00%	10,143,152
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
19	8-7	SAVR Reverse Retirements (IS)	SUBS	Overland		271,567	0.00%	615,253	0.01%	2,344,456	0.02%	3,231,276
				ORA	(2)	271,567	0.00%	615,253	0.01%	2,344,456	0.02%	3,231,276
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
20	8-8	Equal Access IEMR Ratemaking Adjustment (IS)	NONE	Overland		0	0.00%	(6,477,055)	-0.06%	0	0.00%	(6,477,055)
	S8-1			ORA	(2)	0	0.00%	(6,477,055)	-0.06%	0	0.00%	(6,477,055)
				TURN	(6)							
				Pacific		0	0.00%	(6,477,055)	-0.06%	0	0.00%	(6,477,055)
21	8-12	Reserve Deficiency Amortization (IS)	SUBS	Overland	(1)	0	0.00%	0	0.00%	362,466,228	3.64%	362,466,228
				ORA	(4)	0	0.00%	0	0.00%	362,466,228	3.64%	362,466,228
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
22	9-22	Ameritech Income Tax Misclass (IS)	SUBS	Overland		0	0.00%	0	0.00%	8,001,866	0.08%	8,001,866

R.01-09-001 / I.01-09-002

Joint Exhibit of Overland Consulting, Inc., ORA, TURN and Pacific Bell
Showing Impact of Audit Corrections on Pacific Bell's Reported IEMR Results for 1997 - 1999

Index #	Report Chapter	Adjustment Description (A) (B)	Status of Dispute	Party	NOTES	1997 Final Adjustments	1997 Individual Adjustment Impact on Rate of Return	1998 Final Adjustments	1998 Individual Adjustment Impact on Rate of Return	1999 Final Adjustments	1999 Individual Adjustment Impact on Rate of Return	Total Audit Period Final Adjustment Amounts
				ORA	(2)	0	0.00%	0	0.00%	8,001,866	0.08%	8,001,866
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
23	9-11	Income Tax Normalization (IS)	SUBS	Overland		(92,198,238)	-0.92%	(5,569,856)	-0.05%	61,264,694	0.61%	(36,503,400)
	S9-3			ORA	(4)	(92,198,238)	-0.92%	(5,569,856)	-0.05%	61,264,694	0.61%	(36,503,400)
	S9-5			TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
24	9-21	Excess Deferred Income Tax (IS)	SUBS	Overland	(1)	0	0.00%	29,624,000	0.29%	29,671,000	0.30%	59,295,000
	S9-6			ORA	(4)	0	0.00%	29,624,000	0.29%	29,671,000	0.30%	59,295,000
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
25	9-24	Sales and Use Tax Accrual (IS)	SUBS	Overland		777,410	0.01%	771,297	0.01%	(2,405,419)	-0.02%	(856,712)
				ORA	(2)	777,410	0.01%	771,297	0.01%	(2,405,419)	-0.02%	(856,712)
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
26	9-24	Employment Tax Error (IS)	SUBS	Overland		0	0.00%	0	0.00%	7,333,353	0.07%	7,333,353
				ORA	(2)	0	0.00%	0	0.00%	7,333,353	0.07%	7,333,353
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
39	15-18	SBC Ops FAS 106 Merger Conforming Expense (IS)	NONE	Overland		0	0.00%	0	0.00%	1,656,603	0.02%	1,656,603
				ORA	(2)	0	0.00%	0	0.00%	1,656,603	0.02%	1,656,603
				TURN	(6)							
				Pacific	(8)	0	0.00%	0	0.00%	1,656,603		1,656,603
40	15-19	AMDOCS Awards SBC	SUBS	Overland		0	0.00%	0	0.00%	252,655	0.00%	252,655

R.01-09-001 / I.01-09-002

Joint Exhibit of Overland Consulting, Inc., ORA, TURN and Pacific Bell
Showing Impact of Audit Corrections on Pacific Bell's Reported IEMR Results for 1997 - 1999

Index #	Report Chapter	Adjustment Description (A) (B)	Status of Dispute	Party	NOTES	1997 Final Adjustments	1997 Individual Adjustment Impact on Rate of Return	1998 Final Adjustments	1998 Individual Adjustment Impact on Rate of Return	1999 Final Adjustments	1999 Individual Adjustment Impact on Rate of Return	Total Audit Period Final Adjustment Amounts
		Operations (IS)										
				ORA	(4)	0	0.00%	0	0.00%	252,655	0.00%	252,655
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
41	15-20	Excess Executive Compensation SBC Operations (IS)	SUBS	Overland		0	0.00%	465,193	0.00%	610,568	0.01%	1,075,761
				ORA	(4)	0	0.00%	465,193	0.00%	610,568	0.01%	1,075,761
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
42	15-21	SBC Ops Sec. Alloc of Parent Mgt Fees (IS)	NONE	Overland		0	0.00%	291,835	0.00%	270,743	0.00%	562,578
				ORA	(2)	0	0.00%	291,835	0.00%	270,743	0.00%	562,578
				TURN	(6)							
				Pacific	(8)	0	0.00%	291,835		270,743		562,578
43	15-22	SBC Ops Call Ctr Depreciation, Merger Implmntatn Exp (IS)	NONE	Overland		0	0.00%	237,025	0.00%	0	0.00%	237,025
				ORA	(2)	0	0.00%	237,025	0.00%	0	0.00%	237,025
				TURN	(6)							
				Pacific	(8)	0	0.00%	237,025		0	0.00%	237,025
44	16-18	SBC Svcs "Excess" Executive Comp Exp (IS)	SUBS	Overland		0	0.00%	109,093	0.00%	107,020	0.00%	216,113
				ORA	(4)	0	0.00%	109,093	0.00%	107,020	0.00%	216,113
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
45	16-19	SBC Svcs, CFL, TRI Sec.Alloc. of Parent Mgt Fees (IS)	NONE	Overland		0	0.00%	265,789	0.00%	216,392	0.00%	482,181
				ORA	(2)	0	0.00%	265,789	0.00%	216,392	0.00%	482,181

R.01-09-001 / I.01-09-002
Joint Exhibit of Overland Consulting, Inc., ORA, TURN and Pacific Bell
Showing Impact of Audit Corrections on Pacific Bell's Reported IEMR Results for 1997 - 1999

Index #	Report Chapter	Adjustment Description (A) (B)	Status of Dispute	Party	NOTES	1997 Final Adjustments	1997 Individual Adjustment Impact on Rate of Return	1998 Final Adjustments	1998 Individual Adjustment Impact on Rate of Return	1999 Final Adjustments	1999 Individual Adjustment Impact on Rate of Return	Total Audit Period Final Adjustment Amounts
				TURN	(6)							
				Pacific	(8)	0	0.00%	265,789		216,392		482,181
46	14-9	Parent "Excess" Executive Compensation Expense (IS)	SUBS	Overland		1,451,564	0.01%	6,534,667	0.06%	6,845,540	0.07%	14,831,771
				ORA	(4)	1,451,564	0.01%	6,534,667	0.06%	6,845,540	0.07%	14,831,771
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
47	14-23	Parent Political and Legislative Influence Expense (IS)	NONE	Overland		8,574,885	0.09%	10,009,837	0.10%	4,186,554	0.04%	22,771,276
				ORA	(2)	8,574,885	0.09%	10,009,837	0.10%	4,186,554	0.04%	22,771,276
				TURN	(6)							
				Pacific	(8)	8,574,885		10,009,837		4,186,554		22,771,276
48	14-26	Parent Legal Expense (IS)	SUBS	Overland		0	0.00%	438,876	0.00%	212,061	0.00%	650,937
				ORA	(4)	0	0.00%	438,876	0.00%	212,061	0.00%	650,937
				TURN	(5)	0	0.00%	438,876	0.00%	212,061	0.00%	650,937
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
49	14-34	Parent Public Relations & Corporate Sponsorship Exp (IS)	SUBS	Overland		1,700,568	0.02%	8,583,357	0.08%	8,818,057	0.09%	19,101,982
				ORA	(4)	1,700,568	0.02%	8,583,357	0.08%	8,818,057	0.09%	19,101,982
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
50	14-33	Parent Corporate Development Expense (IS)	SUBS	Overland		0	0.00%	3,068,824	0.03%	3,506,106	0.04%	6,574,930
				ORA	(4)	0	0.00%	3,068,824	0.03%	3,506,106	0.04%	6,574,930
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0

R.01-09-001 / I.01-09-002
Joint Exhibit of Overland Consulting, Inc., ORA, TURN and Pacific Bell
Showing Impact of Audit Corrections on Pacific Bell's Reported IEMR Results for 1997 - 1999

Index #	Report Chapter	Adjustment Description (A) (B)	Status of Dispute	Party	NOTES	1997 Final Adjustments	1997 Individual Adjustment Impact on Rate of Return	1998 Final Adjustments	1998 Individual Adjustment Impact on Rate of Return	1999 Final Adjustments	1999 Individual Adjustment Impact on Rate of Return	Total Audit Period Final Adjustment Amounts
51	14-35	Parent Strategic Planning Expense (IS)	SUBS	Overland		1,675,592	0.02%	532,041	0.01%	409,813	0.00%	2,617,446
				ORA	(4)	1,675,592	0.02%	532,041	0.01%	409,813	0.00%	2,617,446
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
52	14-38	Parent Contributions, Memberships, Foundation Exp (IS)	NONE	Overland		161,013	0.00%	657,620	0.01%	(3,067,831)	-0.03%	(2,249,198)
				ORA	(2)	161,013	0.00%	657,620	0.01%	(3,067,831)	-0.03%	(2,249,198)
				TURN	(6)							
				Pacific	(8)	161,013		657,620		(3,067,831)		(2,249,198)
53	14-39	Parent Out of Period Expense (IS)	SUBS	Overland		(3,442,873)	-0.03%	3,360,784	0.03%	0	0.00%	(82,089)
				ORA	(2)	(3,442,873)	-0.03%	3,360,784	0.03%	0	0.00%	(82,089)
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
54	14-40	Parent Merger Conforming Expense (IS)	NONE	Overland		0	0.00%	0	0.00%	454,553	0.00%	454,553
				ORA	(2)	0	0.00%	0	0.00%	454,553	0.00%	454,553
				TURN	(6)							
				Pacific	(8)	0	0.00%	0	0.00%	454,553		454,553
55	14-41	Parent Impact of Adjustmts on Billings to PBD (IS)		Overland	(9)	770,974	0.01%	3,914,927	0.04%	4,453,797	0.04%	9,139,698
				ORA	(2),(4)	770,974	0.01%	3,914,927	0.04%	4,453,797	0.04%	9,139,698
55i		PBD Parent Impact Legal Expense (IS)		TURN	(5)	0	0.00%	24,752	0.00%	8,965	0.00%	33,717
55a		PBD Parent Impact Contributions	NONE	Pacific	(8)	75,500		259,236		195,782		530,518

R.01-09-001 / I.01-09-002

Joint Exhibit of Overland Consulting, Inc., ORA, TURN and Pacific Bell
Showing Impact of Audit Corrections on Pacific Bell's Reported IEMR Results for 1997 - 1999

Index #	Report Chapter	Adjustment Description (A) (B)	Status of Dispute	Party	NOTES	1997 Final Adjustments	1997 Individual Adjustment Impact on Rate of Return	1998 Final Adjustments	1998 Individual Adjustment Impact on Rate of Return	1999 Final Adjustments	1999 Individual Adjustment Impact on Rate of Return	Total Audit Period Final Adjustment Amounts
		Memberships (IS)										
55b		PBD Parent Impact Corporate Acquisitions (IS)	SUBS	Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
55c		PBD Parent Impact Corporate Sponsorships (IS)	SUBS	Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
55d		PBD Parent Impact Excess Executive Compensation (IS)	SUBS	Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
55e		PBD Parent Impact Lobbying (IS)	NONE	Pacific	(8)	389,744		729,081		881,323		2,000,148
55f		PBD Parent Impact Special Executive Payments (IS)	SUBS	Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
55g		PBD Parent Impact Public Relations Expense (IS)	SUBS	Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
55h		PBD Parent Impact Strategic Planning Expense (IS)	SUBS	Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
55i		PBD Parent Impact Legal Expense (IS)	SUBS	Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
55j		PBD Parent Impact Management Fee (IS)	NONE	Pacific	(8)	0	0.00%	1,145,479		1,248,344		2,393,823
55k		PBD Parent Impact Employee Transfer Fees (IS)	NONE	Pacific	(8)	58,754		0	0.00%	0	0.00%	58,754
56	14-41	MSI USA "Excess" Executive Comp Billed Directly (IS)	SUBS	Overland		0	0.00%	0	0.00%	1,833,222	0.02%	1,833,222
				ORA	(4)	0	0.00%	0	0.00%	1,833,222	0.02%	1,833,222
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
57	17-18	Parent PB Employee Trsfr Fees Billed Back to PB (IS)	NONE	Overland		626,616	0.01%	0	0.00%	0	0.00%	626,616
				ORA	(2)	626,616	0.01%	0	0.00%	0	0.00%	626,616

R.01-09-001 / I.01-09-002
Joint Exhibit of Overland Consulting, Inc., ORA, TURN and Pacific Bell
Showing Impact of Audit Corrections on Pacific Bell's Reported IEMR Results for 1997 - 1999

Index #	Report Chapter	Adjustment Description (A) (B)	Status of Dispute	Party	NOTES	1997 Final Adjustments	1997 Individual Adjustment Impact on Rate of Return	1998 Final Adjustments	1998 Individual Adjustment Impact on Rate of Return	1999 Final Adjustments	1999 Individual Adjustment Impact on Rate of Return	Total Audit Period Final Adjustment Amounts
				TURN	(6)							
				Pacific	(8)	626,616		0	0.00%	0	0.00%	626,616
58	17-18	Fees for Employees Transferred in 1999 (IS)	NONE	Overland	(11)	0	0.00%	0	0.00%	0	0.00%	0
				ORA	(4)	0	0.00%	0	0.00%	0	0.00%	0
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
59	18-2	Nevada Bell Net Directory Revenue (IS)	NONE	Overland		0	0.00%	0	0.00%	(11,253,000)	-0.11%	(11,253,000)
	18-7			ORA	(2)	0	0.00%	0	0.00%	(11,253,000)	-0.11%	(11,253,000)
				TURN	(6)							
				Pacific		0	0.00%	0	0.00%	(11,253,000)	-0.11%	(11,253,000)
ORA	19	ASI - ADSL Development Cost Treatment (IS)	SUBS	Overland		0	0.00%	0	0.00%	0	0.00%	0
				ORA	(3)	2,439,732	0.02%	5,577,046	0.05%	86,291,540	0.87%	94,308,318
				TURN	(5)	2,439,732	0.02%	5,577,046	0.05%	86,291,540	0.87%	94,308,318
				Pacific	(10)	0	0.00%	0	0.00%	0	0.00%	0
60b	20-20	Depreciation Expense Timing Adjustment (IS)	SUBS	Overland	(1)	0	0.00%	0	0.00%	2,917,083	0.03%	2,917,083
				ORA	(2)	0	0.00%	0	0.00%	2,917,083	0.03%	2,917,083
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
61	20-22	Advertising Direct Assignment and Common Allocations (IS)	SUBS	Overland		0	0.00%	1,930,885	0.02%	1,752,588	0.02%	3,683,473
				ORA	(2)	0	0.00%	1,930,885	0.02%	1,752,588	0.02%	3,683,473
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0

R.01-09-001 / I.01-09-002
Joint Exhibit of Overland Consulting, Inc., ORA, TURN and Pacific Bell
Showing Impact of Audit Corrections on Pacific Bell's Reported IEMR Results for 1997 - 1999

Index #	Report Chapter	Adjustment Description (A) (B)	Status of Dispute	Party	NOTES	1997 Final Adjustments	1997 Individual Adjustment Impact on Rate of Return	1998 Final Adjustments	1998 Individual Adjustment Impact on Rate of Return	1999 Final Adjustments	1999 Individual Adjustment Impact on Rate of Return	Total Audit Period Final Adjustment Amounts
62	20-31	Customer Service Non-Productive Salary Allocations (IS)	SUBS	Overland		(1,039,093)	-0.01%	(3,366,101)	-0.03%	(4,813,537)	-0.05%	(9,218,731)
				ORA	(2)	(1,039,093)	-0.01%	(3,366,101)	-0.03%	(4,813,537)	-0.05%	(9,218,731)
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
63	20-37	Affiliate Marketing Services Revenue (IS)	SUBS	Overland		0	0.00%	4,420,889	0.04%	17,936,810	0.18%	22,357,699
				ORA	(3)	0	0.00%	3,235,271	0.03%	13,689,808	0.14%	16,925,079
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
64	20-48	Non-regulated Tracking Code Direct Assignment Errors (IS)	NONE	Overland		7,398	0.00%	4,250,163	0.04%	3,237,874	0.03%	7,495,435
				ORA	(2)	7,398	0.00%	4,250,163	0.04%	3,237,874	0.03%	7,495,435
				TURN	(6)							
				Pacific		7,398	0.00%	4,250,163	0.04%	3,237,874	0.03%	7,495,435
65	20-48	National-Local Strategy Implementation (IS)	SUBS	Overland		0	0.00%	0	0.00%	3,695,373	0.04%	3,695,373
				ORA	(2)	0	0.00%	0	0.00%	3,695,373	0.04%	3,695,373
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
66	20-25	1997 Corporate Sponsorship Costs (IS)	SUBS	Overland		1,014,546	0.01%	0	0.00%	0	0.00%	1,014,546
				ORA	(2)	1,014,546	0.01%	0	0.00%	0	0.00%	1,014,546
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
67	20-50	Customer Premise Equipment Costs (IS)	NONE	Overland		0	0.00%	10,097,537	0.10%	3,467,830	0.03%	13,565,367
				ORA	(2)	0	0.00%	10,097,537	0.10%	3,467,830	0.03%	13,565,367

R.01-09-001 / I.01-09-002
Joint Exhibit of Overland Consulting, Inc., ORA, TURN and Pacific Bell
Showing Impact of Audit Corrections on Pacific Bell's Reported IEMR Results for 1997 - 1999

Index #	Report Chapter	Adjustment Description (A) (B)	Status of Dispute	Party	NOTES	1997 Final Adjustments	1997 Individual Adjustment Impact on Rate of Return	1998 Final Adjustments	1998 Individual Adjustment Impact on Rate of Return	1999 Final Adjustments	1999 Individual Adjustment Impact on Rate of Return	Total Audit Period Final Adjustment Amounts
				TURN	(6)							
				Pacific		0	0.00%	10,097,537	0.10%	3,467,830	0.03%	13,565,367
68	S5-1	PIU Accrual (IS)	SUBS	Overland		(8,694,340)	-0.09%	0	0.00%	0	0.00%	(8,694,340)
				ORA	(2)	(8,694,340)	-0.09%	0	0.00%	0	0.00%	(8,694,340)
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
69	S5-2	USOAR Turnaround Accrual (IS)	SUBS	Overland		(13,701,303)	-0.14%	0	0.00%	0	0.00%	(13,701,303)
				ORA	(2)	(13,701,303)	-0.14%	0	0.00%	0	0.00%	(13,701,303)
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
70b	S6-1	LNP Depreciation (IS)	SUBS	Overland	(1)	683,085	0.01%	1,568,573	0.02%	2,491,352	0.03%	4,743,010
				ORA	(4)	683,085	0.01%	1,568,573	0.02%	2,491,352	0.03%	4,743,010
				TURN	(5)	683,085	0.01%	1,568,573	0.02%	2,491,352	0.03%	4,743,010
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
71b	10-17	AFUDC Depreciation Expense (IS)	SUBS	Overland	(1)	105,472	0.00%	388,706	0.00%	507,214	0.01%	1,001,392
	S10-1			ORA	(2)	105,472	0.00%	388,706	0.00%	507,214	0.01%	1,001,392
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
		Rate Base Adjustments										
27	11-5	Cash Working Capital (RB)	BOTH	Overland		(391,374,000)	0.26%	(513,422,000)	0.48%	(508,363,000)	0.52%	(1,413,159,000)
	S11-5			ORA	(3)	(511,550,000)	0.35%	(530,735,000)	0.50%	(378,865,000)	0.38%	(1,421,150,000)
				TURN	(5)	(511,550,000)	0.35%	(530,735,000)	0.50%	(378,865,000)	0.38%	(1,421,150,000)
				Pacific		(142,169,000)	0.09%	(91,320,000)	0.08%	(91,103,000)	0.09%	(324,592,000)

R.01-09-001 / I.01-09-002
Joint Exhibit of Overland Consulting, Inc., ORA, TURN and Pacific Bell
Showing Impact of Audit Corrections on Pacific Bell's Reported IEMR Results for 1997 - 1999

Index #	Report Chapter	Adjustment Description (A) (B)	Status of Dispute	Party	NOTES	1997 Final Adjustments	1997 Individual Adjustment Impact on Rate of Return	1998 Final Adjustments	1998 Individual Adjustment Impact on Rate of Return	1999 Final Adjustments	1999 Individual Adjustment Impact on Rate of Return	Total Audit Period Final Adjustment Amounts
28	11-28	Prepaid Directory Expense (RB)	SUBS	Overland		93,805,000	-0.06%	83,904,000	-0.07%	71,382,000	-0.07%	249,091,000
				ORA	(2)	93,805,000	-0.06%	83,904,000	-0.07%	71,382,000	-0.07%	249,091,000
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
29	11-30	SFAS 112 Liability (RB)	SUBS	Overland		(213,204,405)	0.14%	(236,462,847)	0.22%	(255,430,427)	0.25%	(705,097,679)
				ORA	(2)	(213,204,405)	0.14%	(236,462,847)	0.22%	(255,430,427)	0.25%	(705,097,679)
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
30	11-31	Vacation Liability (RB)	SUBS	Overland		(51,867,976)	0.03%	(51,359,429)	0.05%	(45,735,145)	0.04%	(148,962,550)
				ORA	(2)	(51,867,976)	0.03%	(51,359,429)	0.05%	(45,735,145)	0.04%	(148,962,550)
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
31	11-31	SFAS 106 Accrued Liability (RB)	SUBS	Overland		124,000	0.00%	(5,998,000)	0.01%	5,352,000	-0.01%	(522,000)
				ORA	(2)	124,000	0.00%	(5,998,000)	0.01%	5,352,000	-0.01%	(522,000)
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
32	11-34	Accrued Contingent Liability (RB)	SUBS	Overland		(28,039,000)	0.02%	(20,106,000)	0.02%	(7,800,000)	0.01%	(55,945,000)
				ORA	(4)	(28,039,000)	0.02%	(20,106,000)	0.02%	(7,800,000)	0.01%	(55,945,000)
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
33	11-28	Prepaid Pension Costs (RB)	SUBS	Overland		52,640,046	-0.03%	159,667,092	-0.14%	269,302,092	-0.25%	481,609,230
	S11-6			ORA	(2)	52,640,046	-0.03%	159,667,092	-0.14%	269,302,092	-0.25%	481,609,230
				TURN	(6)							

R.01-09-001 / I.01-09-002
Joint Exhibit of Overland Consulting, Inc., ORA, TURN and Pacific Bell
Showing Impact of Audit Corrections on Pacific Bell's Reported IEMR Results for 1997 - 1999

Index #	Report Chapter	Adjustment Description (A) (B)	Status of Dispute	Party	NOTES	1997 Final Adjustments	1997 Individual Adjustment Impact on Rate of Return	1998 Final Adjustments	1998 Individual Adjustment Impact on Rate of Return	1999 Final Adjustments	1999 Individual Adjustment Impact on Rate of Return	Total Audit Period Final Adjustment Amounts
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
34	10-22	SFAS 106 Plant (RB)	SUBS	Overland		4,892,000	0.00%	(7,621,000)	0.01%	(90,167,000)	0.09%	(92,896,000)
				ORA	(2)	4,892,000	0.00%	(7,621,000)	0.01%	(90,167,000)	0.09%	(92,896,000)
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
35	10-22	Restructure Reserve (RB)	AMT	Overland		(29,070,727)	0.02%	(29,024,711)	0.03%	(28,975,159)	0.03%	(87,070,597)
	S10-3			ORA	(2)	(29,070,727)	0.02%	(29,024,711)	0.03%	(28,975,159)	0.03%	(87,070,597)
				TURN	(6)							
				Pacific		(4,374,000)	0.00%	(4,350,000)	0.00%	(4,350,000)	0.00%	(13,074,000)
36	10-23	Accumulated Reserve for Depreciation (RB)	SUBS	Overland	(1)	14,069,957	-0.01%	36,308,845	-0.03%	244,868,120	-0.23%	295,246,922
				ORA	(2)	14,069,957	-0.01%	36,308,845	-0.03%	244,868,120	-0.23%	295,246,922
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
37	9-23	Accumulated Deferred Income Tax (RB)	SUBS	Overland		(57,788,323)	0.04%	(11,713,582)	0.01%	89,052,818	-0.09%	19,550,913
				ORA	(4)	(57,788,323)	0.04%	(11,713,582)	0.01%	89,052,818	-0.09%	19,550,913
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
38	9-21	Excess Deferred Income Tax (RB)	SUBS	Overland	(1)	0	0.00%	12,800,000	-0.01%	38,400,000	-0.04%	51,200,000
				ORA	(4)	0	0.00%	12,800,000	-0.01%	38,400,000	-0.04%	51,200,000
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
ORA	19	ASI - ADSL Development Cost Treatment (RB)	SUBS	Overland		0	0.00%	0	0.00%	0	0.00%	0
				ORA	(3)	0	0.00%	(10,600,000)	-0.10%	(209,176,000)	-2.10%	(219,776,000)

R.01-09-001 / I.01-09-002

Joint Exhibit of Overland Consulting, Inc., ORA, TURN and Pacific Bell
Showing Impact of Audit Corrections on Pacific Bell's Reported IEMR Results for 1997 - 1999

Index #	Report Chapter	Adjustment Description (A) (B)	Status of Dispute	Party	NOTES	1997 Final Adjustments	1997 Individual Adjustment Impact on Rate of Return	1998 Final Adjustments	1998 Individual Adjustment Impact on Rate of Return	1999 Final Adjustments	1999 Individual Adjustment Impact on Rate of Return	Total Audit Period Final Adjustment Amounts
				TURN	(5)	0	0.00%	(10,600,000)	-0.10%	(209,176,000)	-2.10%	(219,776,000)
				Pacific	(10)	0	0.00%	0	0.00%	0	0.00%	0
60a	20-20	Depreciation Expense Timing Adjustment (RB)	SUBS	Overland	(1)	0	0.00%	0	0.00%	1,728,488	0.00%	1,728,488
				ORA	(2)	0	0.00%	0	0.00%	1,728,488	0.00%	1,728,488
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
70a	S6-1	LNP Capital Costs (RB)	SUBS	Overland	(1)	(14,315,457)	0.01%	(32,338,163)	0.03%	(42,836,992)	0.04%	(89,490,612)
				ORA	(4)	(14,315,457)	0.01%	(32,338,163)	0.03%	(42,836,992)	0.04%	(89,490,612)
				TURN	(5)	(14,315,457)	0.01%	(32,338,163)	0.03%	(42,836,992)	0.04%	(89,490,612)
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
71a	10-17	AFUDC (RB)	SUBS	Overland	(1)	(2,327,000)	0.00%	(8,370,000)	0.01%	(12,964,000)	0.01%	(23,661,000)
	S10-1			ORA	(2)	(2,327,000)	0.00%	(8,370,000)	0.01%	(12,964,000)	0.01%	(23,661,000)
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
72	S10-2	PBOP Pre-Funding Plant Adj. (RB)	SUBS	Overland		13,312,000	-0.01%	13,312,000	-0.01%	13,312,000	-0.01%	39,936,000
				ORA	(2)	13,312,000	-0.01%	13,312,000	-0.01%	13,312,000	-0.01%	39,936,000
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
		Net Income Effect of Audit Corrections		Overland		431,399,621		639,617,502		911,081,711		1,982,098,834
		Net Rate Base Effect of Audit Corrections		Overland		(609,143,885)		(610,423,795)		(258,874,205)		(1,478,441,885)
		Net Income As Reported				652,499,328						

R.01-09-001 / I.01-09-002
Joint Exhibit of Overland Consulting, Inc., ORA, TURN and Pacific Bell
Showing Impact of Audit Corrections on Pacific Bell's Reported IEMR Results for 1997 - 1999

Index #	Report Chapter	Adjustment Description (A) (B)	Status of Dispute	Party	NOTES	1997 Final Adjustments	1997 Individual Adjustment Impact on Rate of Return	1998 Final Adjustments	1998 Individual Adjustment Impact on Rate of Return	1999 Final Adjustments	1999 Individual Adjustment Impact on Rate of Return	Total Audit Period Final Adjustment Amounts
		On Pac Bell IEMR						922,472,419		962,198,083		
		Net Income Effect of Audit Corrections		Overland		431,399,621		639,617,502		911,081,711		
		Audit-Corrected Net Income		Overland		1,083,898,949		1,562,089,921		1,873,279,794		
		0										
		Rate Base As Reported On Pac Bell IEMR				10,057,147,720		10,170,676,085		9,963,602,286		
		Rate Base Effect of Audit Corrections		Overland		(609,143,885)		(610,423,795)		(258,874,205)		
		Audit-Corrected Rate Base		Overland		9,448,003,835		9,560,252,290		9,704,728,081		
		Rate of Return As Reported By Pacific Bell				6.49%		9.07%		9.66%		
		Rate of Return Impact of Audit Adjustments		Overland		4.98%		7.27%		9.65%		
		Audit-Corrected Rate of Return		Overland		11.47%		16.34%		19.30%		
		Net Income Effect of Audit Corrections		ORA		428,511,826		623,187,148		1,003,300,454		2,054,999,428
		Net Rate Base Effect of Audit Corrections		ORA		(729,319,885)		(638,336,795)		(338,552,205)		(1,706,208,885)
		Net Income As Reported On Pac Bell IEMR				652,499,328		922,472,419		962,198,083		
		Net Income Effect of Audit Corrections		ORA		428,511,826		623,187,148		1,003,300,454		
		Audit-Corrected Net Income		ORA		1,081,011,154		1,545,659,567		1,965,498,537		
		Rate Base As Reported On Pac Bell IEMR				10,057,147,000		10,170,675,000		9,963,602,000		
		Rate Base Effect of Audit Corrections		ORA		(729,319,885)		(638,336,795)		(338,552,205)		
		Audit-Corrected Rate Base		ORA		9,327,827,115		9,532,338,205		9,625,049,795		

R.01-09-001 / I.01-09-002
Joint Exhibit of Overland Consulting, Inc., ORA, TURN and Pacific Bell
Showing Impact of Audit Corrections on Pacific Bell's Reported IEMR Results for 1997 - 1999

Index #	Report Chapter	Adjustment Description (A) (B)	Status of Dispute	Party	NOTES	1997 Final Adjustments	1997 Individual Adjustment Impact on Rate of Return	1998 Final Adjustments	1998 Individual Adjustment Impact on Rate of Return	1999 Final Adjustments	1999 Individual Adjustment Impact on Rate of Return	Total Audit Period Final Adjustment Amounts
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		Rate of Return As Reported By Pacific Bell				6.49%		9.07%		9.66%		
		Rate of Return Impact of Audit Adjustments		ORA		5.10%		7.14%		10.76%		
		Audit-Corrected Rate of Return		ORA		11.59%		16.21%		20.42%		
		Net Income Effect of Retroactive Audit Corrections		PACIFIC	(12)	(7,438,454)		26,011,591		20,229,744		38,802,881
		Net Income Effect of Audit Corrections in Year 2002		PACIFIC	(12)	36,855,318		17,879,942		8,268,949		63,004,209
		Net Rate Base Effect of Audit Corrections		PACIFIC		(146,543,000)		(95,670,000)		(95,453,000)		(337,666,000)
		Net Income As Reported On Pac Bell IEMR				652,499,328		922,472,419		962,198,083		
		Net Income Effect of Audit Corrections		PACIFIC		(7,438,454)		26,011,591		20,229,744		
		Audit-Corrected Net Income		PACIFIC		645,060,874		948,484,010		982,427,827		
		Rate Base As Reported On Pac Bell IEMR				10,057,147,000		10,170,675,000		9,963,602,000		
		Rate Base Effect of Audit Corrections		PACIFIC		(146,543,000)		(95,670,000)		(95,453,000)		
		Audit-Corrected Rate Base		PACIFIC		9,910,604,000		10,075,005,000		9,868,149,000		
		Rate of Return As Reported By Pacific Bell				6.49%		9.07%		9.66%		
		Rate of Return Impact of Audit Adjustments		PACIFIC		0.02%		0.34%		0.30%		
		Audit-Corrected Rate of Return		PACIFIC		6.51%		9.41%		9.96%		

KEYS TO PRESENTATION:

- A The impact of the CPUC's income tax flowthrough policy on each adjustment is reflected with the

R.01-09-001 / I.01-09-002
 Joint Exhibit of Overland Consulting, Inc., ORA, TURN and Pacific Bell
 Showing Impact of Audit Corrections on Pacific Bell's Reported IEMR Results for 1997 - 1999

Index #	Report Chapter	Adjustment Description (A) (B)	Status of Dispute	Party	NOTES	1997 Final Adjustments	1997 Individual Adjustment Impact on Rate of Return	1998 Final Adjustments	1998 Individual Adjustment Impact on Rate of Return	1999 Final Adjustments	1999 Individual Adjustment Impact on Rate of Return	Total Audit Period Final Adjustment Amounts
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- B adjustment.
 The rate of return impact of individual adjustments is calculated using Pacific's reported rate base and operating income.

STATUS OF DISPUTE:

- NONE Adjustments recommended by Overland that are NOT disputed by Pacific.
- AMT Adjustments recommended by Overland that are disputed by Pacific in AMOUNT.
- SUBS Adjustments recommended by Overland that are disputed by Pacific in SUBSTANCE.
- BOTH Adjustments recommended by Overland that are disputed by Pacific BOTH in AMOUNT and in SUBSTANCE.

FOOTNOTES:

- 1 This adjustment, as proposed by Overland, has both an income and rate base impact.
- 2 Because ORA did not affirmatively address this issue in filed testimony, ORA is not contesting the adjustment quantification presented by Overland and supported by the Audit Report.
- 3 ORA has presented an alternative adjustment quantification.
- 4 ORA presented testimony on this issue, but did not propose an alternative adjustment.
- 5 TURN's calculated adjustment includes only those issues TURN has addressed in its opening and reply brief.

R.01-09-001 / I.01-09-002

**Joint Exhibit of Overland Consulting, Inc., ORA, TURN and Pacific Bell
Showing Impact of Audit Corrections on Pacific Bell's Reported IEMR Results for 1997 - 1999**

Index #	Report Chapter	Adjustment Description (A) (B)	Status of Dispute	Party	NOTES	1997 Final Adjustments	1997 Individual Adjustment Impact on Rate of Return	1998 Final Adjustments	1998 Individual Adjustment Impact on Rate of Return	1999 Final Adjustments	1999 Individual Adjustment Impact on Rate of Return	Total Audit Period Final Adjustment Amounts
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- TURN is not presenting total intrastate income, rate base and rate of return impacts for the limited set of issues TURN addressed.
- 6 On those issues TURN has not affirmatively addressed in briefs, TURN does not dispute the adjustment quantification presented by Overland on behalf of the Telecommunications Division.
- 7 Because Pacific disputes the need for any adjustment for this issue, Pacific has not confirmed Overland's calculation.
- 8 Pacific's position is that this adjustment should be not be made retroactively, but rather in the current period (2002).
Accordingly, no rate of return impact is shown.
- 9 Pacific breaks this adjustment into eleven components, disputing some portions of the adjustment, but not all.
There is no disagreement on the break out.
- 10 Because Pacific disputes the need for any adjustment for this issue, Pacific has not confirmed ORA's calculation.
- 11 Based on information Pacific Bell provided for the first time in written testimony, the adjustment is no longer appropriate.
- 12 Pacific's position segregates the adjustments between those which should be applied retroactively to the IEMR

APPENDIX C

R.01-09-001 / I.01-09-002

**Joint Schedule of Overland Consulting, Inc.'s, ORA's, and TURN's
Position on Adjustments (as requested by ALJ Sarah Thomas)
9/20/2002**

Index #	Rate Base or Income Stmt	Adjust Ref.	Report Chapter	Testimony Reference	Adjustment Description	Overland Position	ORA Position	TURN Position
Income Statement Adjustments								
1	IS	REG-01	5 - 13	GH Reply 5	Unsupported Contingent Liabilities - Revenues (IS) - Increase revenues to eliminate unsupported and unauditable contingent liability accruals.	Pacific Bell did not provide the information needed to audit the contested accruals. The limited information provided by Pacific Bell demonstrated the accrual amounts were not reasonable.	Concur with Overland. Also concur with TURN re waiver of privilege and that liabilities should be accounted for on an as-paid basis.	Pacific Bell failed to demonstrate that providing the information needed to audit the contested accruals would constitute waiver of any privilege. Therefore, these liabilities should be accounted for on an as-paid basis.
2	IS	REG-02	5 -14		Bellcore Dividends (IS) - Increase 1997 revenues to correct an error in an IEMR ratemaking adjustment.	Pacific Bell admits this accounting error occurred and accepts the correction. Pacific Bell posted the Bellcore Dividends IEMR ratemaking adjustment in the wrong direction.	Concur with Overland	
3	IS	REG-03	5 - 15	GH Reply 16	Uncollectible Revenues - RCRMS (PacBell flows through) (IS) - Reduce 1997 uncollectible accounts provision to eliminate costs that should have been accrued in 1996.	The information available at the end of 1996 was sufficient to support an accrual of the costs.	Concur with Overland	

R.01-09-001 / I.01-09-002

**Joint Schedule of Overland Consulting, Inc.'s, ORA's, and TURN's
Position on Adjustments (as requested by ALJ Sarah Thomas)
9/20/2002**

Index #	Rate Base or Income Stmt	Adjust Ref.	Report Chapter	Testimony Reference	Adjustment Description	Overland Position	ORA Position	TURN Position
4	IS	REG-04	5 - 19		Gain on Sale of Bellcore (IS) - Increase 1997 other operating income to correct an accounting error.	Pacific Bell accepts this correction. The CPUC allocated 50% of the gain on the sale of Bellcore to ratepayers and required a refund. Pacific Bell recorded the refund above the line. Therefore, 50% of the gain should have been recorded above-the-line. Pacific Bell recorded the entire gain below the line.	Concur with Overland	
5	IS	REG-05	6 - 15, S6 - 1	GH Reply 2	Local Number Portability Costs (IS) - Reduce expense to correct a separations error.	Pacific Bell accepts the correction for periods after April 1998. The costs incurred prior to May 1998 are exclusively interstate costs that are recovered through an FCC tariff. IEMR reports should be revised when subsequent information reveals the separations treatment used in the original report was incorrect. In addition, Pacific Bell should have deferred the costs as a regulatory asset.	Concur with Overland	The costs incurred prior to May 1998 should have been deferred as a regulatory asset pursuant to FAS 71 requirements. Pacific Bell had sufficient information to estimate the probable amount of cost recovery in early 1996.

R.01-09-001 / I.01-09-002

**Joint Schedule of Overland Consulting, Inc.'s, ORA's, and TURN's
Position on Adjustments (as requested by ALJ Sarah Thomas)
9/20/2002**

Index #	Rate Base or Income Stmt	Adjust Ref.	Report Chapter	Testimony Reference	Adjustment Description	Overland Position	ORA Position	TURN Position
6	IS	REG-06	6 - 19	GH Open 4	Local Competition Costs (IS) - Reduce expense to correct an accounting error. Pacific Bell failed to recognize a regulatory asset.	The costs should have been deferred as a regulatory asset in November 1998 pursuant to FAS 71 requirements. Pacific Bell had sufficient information to estimate the probable amount of cost recovery in November 1998.	ORA generally concurs with Overland that these costs should be removed from the audit period. The Commission has established a mechanism to allow SBC Pacific to recover these costs through intrastate rates, beginning in 2001. Absent these adjustments, the Company could over-recover these costs from ratepayers.	The costs incurred during the audit period should have been deferred as a regulatory asset pursuant to FAS 71 requirements. Pacific Bell had sufficient information to estimate the probable amount of cost recovery no later than early 1996.
7	IS	REG-07	6 - 22	GH Reply 10	Merger Savings Allocation (IS) - Modify IEMR ratemaking adjustment to correct errors and reflect the SBC/Pacific Telesis merger savings forecast adopted by the CPUC.	The timing of the IEMR ratemaking adjustments should reflect the merger savings forecast adopted by the CPUC in the Merger Decision.	Concur with Pacific Bell	
8	IS	REG-08	6 - 27		Advanced Communications Network (IS) - Reduce expense to eliminate plant abandonment costs that should have been charged below-the-line.	Pacific Bell accepts this correction. Pacific Bell recorded part of the abandonment costs for this project above-the-line. The costs should have been charged to below-the-line accounts.	Concur with Overland	

R.01-09-001 / I.01-09-002

**Joint Schedule of Overland Consulting, Inc.'s, ORA's, and TURN's
Position on Adjustments (as requested by ALJ Sarah Thomas)
9/20/2002**

Index #	Rate Base or Income Stmt	Adjust Ref.	Report Chapter	Testimony Reference	Adjustment Description	Overland Position	ORA Position	TURN Position
9	IS	REG-09	6 - 31	GH Reply 9	Software Buy-Out Agreement (IS) - Reduce expense to correct accounting for restructuring of contract payment obligations.	The substance of the contract buy-out was the advance payment of an operating expense in exchange for a price reduction. Advance payments of operating expenses should be charged to prepaid asset accounts under the FCC's Uniform System of Accounts. Pacific Bell charged the buy-out payment obligation directly to expense. Pacific Bell should have deferred the buy-out payment as a prepaid asset and amortized the prepayment over the payment period specified in the original contract.	Concur with Overland	
10	IS	REG-10	6 - 32	GH Reply 5	Unsupported Contingent Liabilities - Operating Expense (IS) - Reduce expenses to eliminate unsupported and unauditable contingent liability accruals.	Pacific Bell did not provide the information needed to audit the contested accruals. The limited information provided by Pacific Bell demonstrated the accrual amounts were not reasonable.	Concur with Overland	Pacific Bell failed to demonstrate that providing the information needed to audit the contested accruals would constitute waiver of any privilege. Therefore, these liabilities should be accounted for on an as-paid basis.

R.01-09-001 / I.01-09-002

**Joint Schedule of Overland Consulting, Inc.'s, ORA's, and TURN's
Position on Adjustments (as requested by ALJ Sarah Thomas)
9/20/2002**

Index #	Rate Base or Income Stmt	Adjust Ref.	Report Chapter	Testimony Reference	Adjustment Description	Overland Position	ORA Position	TURN Position
11	IS	REG-11	6 - 34		Incentive Pay Accrual (IS) - Adjust TEAM award accruals to equal actual payouts.	Team award accrual amounts and payout levels are both completely within the control of management. Therefore, audit adjusted expenses should reflect the actual payout level rather than the estimates accrued by Pacific Bell.	Concur with Overland	
12	IS	REG-12	6 - 37		ISP-Bound Traffic Separations (IS) - Increase 1997 expense to correct separations error.	Pacific Bell accepts this correction. The FCC determined that Pacific Bell's separations treatment of internet bound traffic was improper and required Pacific Bell to retroactively revise its 1997 FCC IEMR. Pacific Bell did not revise its 1997 CPUC basis IEMR.	Concur with Overland	

R.01-09-001 / I.01-09-002
Joint Schedule of Overland Consulting, Inc.'s, ORA's, and TURN's
Position on Adjustments (as requested by ALJ Sarah Thomas)
9/20/2002

Index #	Rate Base or Income Stmt	Adjust Ref.	Report Chapter	Testimony Reference	Adjustment Description	Overland Position	ORA Position	TURN Position
13	IS	REG-13	6 - 36		Uncollectible Settlements - RCRMS (IS) - Reduce expense to eliminate contract billing settlements that should have been accrued in 1996.	The information available at the end of 1996 was sufficient to support an accrual of the costs.	Concur with Overland	
14	IS	REG-14	7 - 9, S7 - 13		Pension Expense (IS) - Reduce expense to reflect the CPUC's pension accounting policy.	Phase 2A issue	Concur with Overland	
15	IS	REG-15,16,17	7 - 13		SFAS 106 (IS) - Reduce expense to reflect the CPUC's PBOP accounting policy.	Phase 2A issue	Concur with Overland	
15	IS	REG-15,16,17	7 - 13, S7 - 6		SFAS 106 - Pension Trust Withdrawal (IS) - Reduce PBOP expense to reflect the CPUC's policy concerning pension trust withdrawals	Phase 2A issue	Concur with Overland	

R.01-09-001 / I.01-09-002

**Joint Schedule of Overland Consulting, Inc.'s, ORA's, and TURN's
Position on Adjustments (as requested by ALJ Sarah Thomas)
9/20/2002**

Index #	Rate Base or Income Stmt	Adjust Ref.	Report Chapter	Testimony Reference	Adjustment Description	Overland Position	ORA Position	TURN Position
16	IS	REG-18	7 - 33	GH Reply 18	SFAS 112 (IS) - Reduce 1997 FAS 112 expense to eliminate impact of a prior period accounting error.	Pacific Bell admits the accounting error occurred. Audit corrected expenses should reflect compliance with CPUC accounting rules in all periods, including periods prior to the audit period. Recorded expenses should be adjusted to eliminate the impact of accounting errors made in prior periods.	Concur with Overland	
17	IS	REG-19	8 - 6	GH Reply 17	Intrabuilding Cable Amortization (IS) - Reduce 1997 and 1998 depreciation expense to eliminate impact of a prior period accounting error.	Pacific Bell admits the accounting error occurred. Audit corrected expenses should reflect compliance with CPUC accounting rules in all periods, including periods prior to the audit period. Recorded expenses should be adjusted to eliminate the impact of accounting errors made in prior periods.	Concur with Overland	
18	IS	REG-20	8 - 7		SAVR Delayed Retirements (IS) - Reduce depreciation expense to reflect corrected plant balances. Pacific Bell failed to record retirements on a timely basis.	The failure to record retirements on a timely basis is an accounting error. Audit corrected expenses should reflect compliance with CPUC accounting rules.	Concur with Overland	

R.01-09-001 / I.01-09-002

**Joint Schedule of Overland Consulting, Inc.'s, ORA's, and TURN's
Position on Adjustments (as requested by ALJ Sarah Thomas)
9/20/2002**

Index #	Rate Base or Income Stmt	Adjust Ref.	Report Chapter	Testimony Reference	Adjustment Description	Overland Position	ORA Position	TURN Position
19	IS	REG-21	8 - 7		SAVR Reverse Retirements (IS) - Reduce depreciation expense to reflect corrected plant balances. The reverse retirements recorded by Pacific Bell were improper.	Pacific Bell's decision to record reverse retirements was not reasonable. Pacific Bell's contention that the book to physical inventory differences were caused by accidental premature book retirements of equipment is not plausible.	Concur with Overland	
20	IS	REG-22	8 - 8, S8 - 1	GH Open 3	Equal Access IEMR Ratemaking Adjustment (IS) - Increase 1998 Depreciation expense to correct an error made in an IEMR ratemaking adjustment.	Pacific Bell accepts this correction. Pacific Bell made a computational error when calculation this IEMR ratemaking adjustment for 1998.	Concur with Overland	
21	IS	REG-23	8 - 12		Reserve Deficiency Amortization (IS) - Reduce 1999 depreciation expense to eliminate reserve deficiency amortization.	Phase 2A issue	Concur with Overland	
22	IS	REG-24	9 - 22		Ameritech Income Tax Misclass (IS) - Reduce 1999 current income tax expense to correct an accounting error. The provision should have been charged below-the-line.	Pacific Bell charged Ameritech merger severance accrual to below-the-line accounts for book purposes. Therefore, the resulting book/tax temporary difference should be classified as a nonoperating temporary difference. This correction only addresses the current income tax treatment of the	Concur with Overland	

R.01-09-001 / I.01-09-002

**Joint Schedule of Overland Consulting, Inc.'s, ORA's, and TURN's
Position on Adjustments (as requested by ALJ Sarah Thomas)
9/20/2002**

Index #	Rate Base or Income Stmt	Adjust Ref.	Report Chapter	Testimony Reference	Adjustment Description	Overland Position	ORA Position	TURN Position
						temporary difference. The deferred income tax treatment of the temporary difference is addressed in the Phase 2A income tax normalization correction.		
23	IS	REG-25	9 - 11, S9 - 3 & 5		Income Tax Normalization (IS) - Reduce deferred income tax expense to reflect the CPUC's flow-through income tax accounting policy.	Phase 2A issue	Concur with Overland	
24	IS	REG-26	9 - 21, S9 - 6		Excess Deferred Income Tax (IS) - Reduce deferred income tax expense to correct an accounting error.	Pacific Bell admits this accounting error occurred and does not contest the amount of the correction. Pacific Bell failed to record amortization of excess deferred income taxes in 1998 and 1999.	Concur with Overland	
25	IS	REG-27	9 - 24		Sales and Use Tax Accrual (IS) - Increase sales and use tax expense to eliminate unsupported accruals.	Pacific Bell did not provide the information needed to audit the accruals.	Concur with Overland	

R.01-09-001 / I.01-09-002

**Joint Schedule of Overland Consulting, Inc.'s, ORA's, and TURN's
Position on Adjustments (as requested by ALJ Sarah Thomas)
9/20/2002**

Index #	Rate Base or Income Stmt	Adjust Ref.	Report Chapter	Testimony Reference	Adjustment Description	Overland Position	ORA Position	TURN Position
26	IS	REG-28	9 - 24	GH Reply 18	Employment Tax Error (IS) - Decrease 1999 payroll taxes to eliminate impact of prior period accounting error.	Pacific Bell admits the error occurred. Audit corrected expenses should reflect compliance with CPUC accounting rules in all periods, including periods prior to the audit period. Recorded expenses should be adjusted to eliminate the impact of accounting errors made in prior periods.	Concur with Overland	
39	IS	AFF-01	15 - 18		SBC Ops FAS 106 Merger Conforming Expense (IS) - Removes a post-retirement benefits accrual incurred as a result of the Ameritech merger from Pacific Bell's regulated accounts.	Consistent with the discussion concerning AFF-16, an adjustment has been proposed for amounts charged by SBC Operations which were not caused by and did not benefit Pacific Bell. This is a baseline requirement for regulated cost recovery per D.86-01-026 (p. 36).	Concur with Overland	
40	IS	AFF-02	15 - 19	RW Reply 4	AMDOCS Awards SBC Operations (IS) - Removes identifiable portions of AMDOCs and Ameritech merger executive awards charged to Pacific Bell by SBC Operations.	Consistent with the discussion concerning AFF-08, an adjustment has been proposed for amounts charged by SBC Operations which were not caused by and did not benefit Pacific Bell. This is a baseline requirement for regulated cost recovery per D.86-01-026 (p. 36).	Concur with Overland	

R.01-09-001 / I.01-09-002

**Joint Schedule of Overland Consulting, Inc.'s, ORA's, and TURN's
Position on Adjustments (as requested by ALJ Sarah Thomas)
9/20/2002**

Index #	Rate Base or Income Stmt	Adjust Ref.	Report Chapter	Testimony Reference	Adjustment Description	Overland Position	ORA Position	TURN Position
41	IS	AFF-03	15 - 20	RW Reply 2, 3; GO Reply 2	Excess Executive Compensation SBC Operations (IS) - Removes amounts exceeding the inflation-adjustment CPUC limit for regulated recovery of executive compensation expense, including salaries and certain severance charged to Pacific Bell by SBC Operations.	Consistent with the discussion concerning AFF-08, an adjustment has been proposed for amounts charged by SBC Operations that were in excess of the inflation-adjusted executive compensation limits established in D.86-01-026 (p. 163).	Concur with Overland	
42	IS	AFF-04	15 - 21		SBC Ops Sec. Alloc of Parent Mgt Fees (IS) - Removes parent company "management fees" charged to Pacific Bell indirectly through SBC Operations.	The SBC "management fees" are unsupported by cost and are additional to the parent company's recovery of fully distributed costs through corporate allocations. They should not have been charged to Pacific Bell (according to the auditors performing the FCC Cost Allocation Manual audit) and are not recoverable through regulated expense.	Concur with Overland	
43	IS	AFF-05	15 - 22		SBC Ops Call Ctr Depreciation, Merger Implmntatn Exp (IS) - Removes certain call center costs, including depreciation, charged by SBC Operations to Pacific Bell's regulated accounts.	SBC Operations allocated excessive call center depreciation expense and costs associated with centralizing the telemarketing function to Pacific Bell in 1998. This reduces Pacific Bell's call center cost allocation to a level consistent with that used to allocate 1998 recurring costs related to the call centers.	Concur with Overland	

R.01-09-001 / I.01-09-002

**Joint Schedule of Overland Consulting, Inc.'s, ORA's, and TURN's
Position on Adjustments (as requested by ALJ Sarah Thomas)
9/20/2002**

Index #	Rate Base or Income Stmt	Adjust Ref.	Report Chapter	Testimony Reference	Adjustment Description	Overland Position	ORA Position	TURN Position
44	IS	AFF-06	16 - 18	RW Reply 2, 3; GO Reply 2	SBC Svcs "Excess" Executive Comp Exp (IS) - Removes identifiable portions of AMDOCs and Ameritech merger executive awards charged to Pacific Bell by SBC Services.	Consistent with the discussion concerning AFF-08, an adjustment has been proposed for amounts charged by SBC Operations which were not caused by and did not benefit Pacific Bell. This is a baseline requirement for regulated cost recovery per D.86-1-026 (p. 36). In addition, these costs were in excess of the inflation-adjusted executive compensation limits established in D.86-01-026 (p. 163).	Concur with Overland	
45	IS	AFF-07	16 - 19		SBC Svcs, CFL, TRI Sec.Alloc. of Parent Mgt Fees (IS) - Removes parent company "management fees" charged to Pacific Bell indirectly through charges from SBC Services, Technology Resources and Center for Learning.	The SBC "management fees" are unsupported by cost and are additional to the parent company's recovery of fully distributed costs through corporate allocations. They should not have been charged to Pacific Bell (according to the auditors performing the FCC Cost Allocation Manual audit) and are not recoverable through regulated expense.	Concur with Overland	

R.01-09-001 / I.01-09-002

**Joint Schedule of Overland Consulting, Inc.'s, ORA's, and TURN's
Position on Adjustments (as requested by ALJ Sarah Thomas)
9/20/2002**

Index #	Rate Base or Income Stmt	Adjust Ref.	Report Chapter	Testimony Reference	Adjustment Description	Overland Position	ORA Position	TURN Position
46	IS	AFF-08	14 - 9	RW Reply 2	Parent "Excess" Executive Compensation Expense (IS) - 1) Removes identifiable portions of AMDOCs and Ameritech merger executive awards charged to Pacific Bell by the parent company. 2) Removes parent company executive compensation exceeding the inflation-adjustment CPUC limit for regulated recovery, including salaries, certain severance and post-retirement "consulting" fees and supplemental retirement income plan (SRIP) expense.	D.86-01-026 established certain baseline requirements for regulated cost recovery of parent and affiliate costs. One of these requirements was that to be recoverable as a regulated cost, parent company charges must provide a "direct and primary benefit" to telephone company customers (p. 36). The executive awards charged to Pacific Bell were not caused by and did not benefit Pacific Bell. One was attributable to affiliate Ameritech and the other to affiliate AMDOCs. In addition, the salaries and severance amounts adjusted were amounts exceeding the inflation-adjustment limit for regulated recovery of executive compensation expense established in Decision 86-01-026 (p. 163) Finally, in addition to exceeding the CPUC compensation limit, the SRIP expense, limited to a few top executives, was charged to Pacific Bell, but a much greater amount of offsetting SRIP income (the funding for the plan) was retained by SBC.	Concur with Overland	

R.01-09-001 / I.01-09-002

**Joint Schedule of Overland Consulting, Inc.'s, ORA's, and TURN's
Position on Adjustments (as requested by ALJ Sarah Thomas)
9/20/2002**

Index #	Rate Base or Income Stmt	Adjust Ref.	Report Chapter	Testimony Reference	Adjustment Description	Overland Position	ORA Position	TURN Position
47	IS	AFF-09	14 - 23	RW Reply 6	Parent Political and Legislative Influence Expense (IS) - Removes political and legislative influence costs incurred by the California External Affairs department of SBC / PTG and charged to Pacific Bell's regulated accounts.	The CPUC adopted the FCC Uniform System of Accounts (USOA) in D.87-12-063. The USOA specifically requires "lobbying" expenditures to be recorded below-the-line in account 7370 - Special Charges. This adjustment brings the accounting for political and legislative influence costs into compliance with CPUC accounting requirements. In addition, contrary to the requirements of D.86-01-026 for regulated cost recovery (p. 36), these costs are incurred for the benefit of SBC executives and SBC shareholders, not Pacific Bell customers.	Concur with Overland	
48	IS	AFF-10	14 - 26	RW Reply 7	Parent Legal Expense (IS) - Removes minor amounts of allocated corporate legal costs associated with entry into the non-regulated, interLATA long distance service market and SBC's intervention to slow down / prevent the approval of a merger of two potential local exchange competitors (AT&T and Media One).	Pacific Bell's allocation of corporate legal cost increased dramatically after SBC took over PTG. Overland was unable to audit corporate legal costs because SBC did not maintain, or would not provide, information regarding the nature of most of the costs. The amounts adjusted were associated with specific cases handled by outside attorneys and were exceptions in which we had cost descriptions. The costs were adjusted because they were not attributable to Pacific Bell's regulated operations. We made no	Concur with Overland	Pacific Bell failed to demonstrate that the legal costs in question were appropriately assigned to its regulated operations, particularly for the AT&T/Media One merger.

R.01-09-001 / I.01-09-002

**Joint Schedule of Overland Consulting, Inc.'s, ORA's, and TURN's
Position on Adjustments (as requested by ALJ Sarah Thomas)
9/20/2002**

Index #	Rate Base or Income Stmt	Adjust Ref.	Report Chapter	Testimony Reference	Adjustment Description	Overland Position	ORA Position	TURN Position
						attempt to adjust amounts from the majority of corporate legal expenses that we were unable to evaluate.		
49	IS	AFF-11	14 - 34	RW Reply 2, 4	Parent Public Relations & Corporate Sponsorship Exp (IS) - This adjustment removes public relations consulting and corporate sports and cultural expenses allocated by SBC to Pacific Bell's regulated accounts.	The CPUC noted in D.86-01-026 that institutional or image building advertising would not be allowed for regulated cost recovery (p. 41). In the same decision, the CPUC determined that public relations expense was a form of "institutional advertising" which did not warrant ratemaking recognition (pp. 41-42). As such, CPUC policy prohibits regulated recovery of both of these costs.	Concur with Overland	
50	IS	AFF-12	14 - 33	RW Reply 8	Parent Corporate Development Expense (IS) - Removes "corporate development" costs of investigations and due diligence on potential foreign investments and various projects unrelated to providing regulated telephone service charged	D.86-01-026 established a baseline requirement that parent company charges must provide "direct and primary benefit" to telephone company customers in order to be recoverable as a regulated cost (p. 36). These costs were not attributable to Pacific Bell and provided no contribution or benefit to regulated local	Concur with Overland	

R.01-09-001 / I.01-09-002

**Joint Schedule of Overland Consulting, Inc.'s, ORA's, and TURN's
Position on Adjustments (as requested by ALJ Sarah Thomas)
9/20/2002**

Index #	Rate Base or Income Stmt	Adjust Ref.	Report Chapter	Testimony Reference	Adjustment Description	Overland Position	ORA Position	TURN Position
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					telephone service charged by SBC to Pacific Bell and recorded in Pacific Bell's accounts.	exchange telephone operations. The costs were not attributable to Pacific Bell's regulated operations; rather they were incurred for the benefit of SBC and its shareholders.		
51	IS	AFF-13	14 - 35	RW Reply 2, 4	Parent Strategic Planning Expense (IS) - Removes corporate "strategic planning" expense.	The CPUC's policy to exclude corporate "strategic planning" expense from regulated customer recovery was set forth in Decision 86-01-026 (pp. 46-47). Pacific Bell / SBC refused to provide the materials necessary to evaluate these costs so that a determination could be made as to the extent they might have benefited Pacific Bell's regulated local exchange operations.	Concur with Overland	
52	IS	AFF-14	14 - 38	RW Reply 9	Parent Contributions, Memberships, Foundation Exp (IS) - Removes contributions and membership costs incorrectly included in Pacific Bell's regulated accounts.	The FCC Uniform System of Account (USOA) as adopted by the CPUC in D.87-12-063 prohibits these costs from being recorded in above-the-line regulated accounts.	Concur with Overland	

R.01-09-001 / I.01-09-002

**Joint Schedule of Overland Consulting, Inc.'s, ORA's, and TURN's
Position on Adjustments (as requested by ALJ Sarah Thomas)
9/20/2002**

Index #	Rate Base or Income Stmt	Adjust Ref.	Report Chapter	Testimony Reference	Adjustment Description	Overland Position	ORA Position	TURN Position
53	IS	AFF-15	14 - 39	RW Reply 9	Parent Out of Period Expense (IS) - Reclassifies 1997 corporate allocations incorrectly charged to 1998 expense back to 1997 expense.	Although recorded on the 1998 books, journal vouchers for the cost clearly indicate that the cost was associated with 1997. Inclusion in 1998 would result in 13 months of corporate allocations charged for 1998, and only 11 for 1997. The costs should be placed in the proper period.	Concur with Overland	
54	IS	AFF-16	14 - 40		Parent Merger Conforming Expense (IS) - Removes a post-retirement benefits accrual incurred as a result of the Ameritech merger from Pacific Bell's regulated accounts.	D.86-01-026 requires that parent company charges must provide "direct and primary benefit" to telephone company customers to be recoverable as a regulated cost (p. 36). Most amounts SBC incurred in consummating the Ameritech merger were correctly retained by the corporation. This amount, which represents a cost to conform Pacific's and Southwestern Bell's post-retirement benefits accounting with that of Ameritech, was improperly charged to Pacific Bell instead of being retained even though it provided no benefit to Pacific Bell's telephone company customers.	Concur with Overland	
55	IS	AFF-17	14 - 41		Parent Impact of Adjustmts on Billings to PBD (IS) - This adjustment removes corporate allocations from SBC discussed in AFF-08 through AFF-16 above that were indirectly charged to	SBC charged costs to Pacific Bell Directory as well as to Pacific Bell. Both sets of allocations impact Pacific Bell's IEMR earnings. This adjustment reflects the effect of the sum of adjustments to corporate allocations that flow	Concur with Overland	

R.01-09-001 / I.01-09-002
Joint Schedule of Overland Consulting, Inc.'s, ORA's, and TURN's
Position on Adjustments (as requested by ALJ Sarah Thomas)
9/20/2002

Index #	Rate Base or Income Stmt	Adjust Ref.	Report Chapter	Testimony Reference	Adjustment Description	Overland Position	ORA Position	TURN Position
					Pacific Bell's IEMR earnings because they were charged to Pacific Bell Directory.	to Pacific Bell's IEMR earnings indirectly through allocation to Pacific Bell Directory.		
56	IS	AFF-18	14 - 41	RW Reply 2	MSI USA "Excess" Executive Comp Billed Directly (IS) - Removes the identifiable portion of corporate executive compensation associated with executives assigned to affiliate MSI USA.	See the discussion of executive compensation for adjustment AFF-08 above. MSI-USA was a corporate entity created to employ former Southwestern Bell region executives and managers in the Pacific Bell region after the merger. Their separation from other Pacific region entities was done to enable them to maintain their Southwestern region benefits packages.	Concur with Overland	
57	IS	AFF-19	17 - 18	RW Reply 10	Parent PB Employee Trsfr Fees Billed Back to PB (IS) - This adjustment removes CPUC employee transfer fees charged by Pacific Bell to SBC that SBC charged back to Pacific Bell.	In D.87-12-067 (Conclusion of Law 35), the CPUC concluded that SBC affiliates are required to pay Pacific Bell a 25 percent-of-salary fee when employees are transferred from Pacific Bell to affiliates. SBC incorrectly charged the cost of some of these fees back to Pacific Bell, effectively canceling them. This adjustment reverses the charge back.	Concur with Overland	

R.01-09-001 / I.01-09-002

**Joint Schedule of Overland Consulting, Inc.'s, ORA's, and TURN's
Position on Adjustments (as requested by ALJ Sarah Thomas)
9/20/2002**

Index #	Rate Base or Income Stmt	Adjust Ref.	Report Chapter	Testimony Reference	Adjustment Description	Overland Position	ORA Position	TURN Position
58	IS	AFF-20	17 - 18	RW Reply 10	Fees for Employees Transferred in 1999 (IS) - Adds employee transfer fee revenue for a large transfer of employees from Pacific Bell to SBC Services that Pacific Bell reported to the CPUC in 1999.	Subsequent to the audit report, Pacific Bell provided evidence to show that the transfers it reported to the CPUC as having occurred in 1999 actually occurred in 2000. The evidence provided showed that the transfer fee revenue was recognized in 2000. Based on the additional evidence, this adjustment is no longer necessary.	Concur with Overland	
59	IS	AFF-21	18 - 2 & 7		Nevada Bell Net Directory Revenue (IS) - This adjustment reduces Pacific Bell Directory's IEMR earnings contribution by correcting the allocation of PBD's earnings between Pacific Bell and Nevada Bell.	Pacific Bell is required to reflect the California earnings of Pacific Bell Directory in its CPUC IEMR earnings calculation. The Directory earnings were improperly overstated on the IEMR report due to an improper allocation of Directory earnings between Nevada and California Directory operations in the IEMR directory earnings calculation. This adjustment corrects the calculation mistake.	Concur with Overland	

R.01-09-001 / I.01-09-002

**Joint Schedule of Overland Consulting, Inc.'s, ORA's, and TURN's
Position on Adjustments (as requested by ALJ Sarah Thomas)
9/20/2002**

Index #	Rate Base or Income Stmt	Adjust Ref.	Report Chapter	Testimony Reference	Adjustment Description	Overland Position	ORA Position	TURN Position
ORA	IS				ADSL Development Costs - This adjustment removes ADSL development costs and increases Pacific Bell's IEMR net earnings.		The net ADSL development costs should be moved below-the-line. A corresponding ratebase adjustment should be made as well.	Pacific Bell should not be allowed to recover development costs through NRF rates, then transfer the ADSL service so that future revenues from that service are not reflected in the IEMR. Instead, the ADSL development costs should be removed from the IEMR during the audit period.
60b	IS	NR-01	20 - 20	GO Reply 10	Depreciation Expense Timing Adjustment (IS) - The allocation between regulated and non-regulated activities was not correct on a year-to-date basis. This entry corrects this error.	When correcting a depreciation expense error in December 1999, Pacific Bell employed current regulated / non-regulated allocation ratios which were not reflective of the actual ratios in use at the time when the errors were originally recorded.	Concur with Overland	
61	IS	NR-02	20 -22	GO Reply 10	Advertising Direct Assignment and Common Allocations (IS) - Directly assigns and allocates these costs to the appropriate regulated and non-regulated activities to the extent possible.	Instead of allocating product advertising expense billed by the Parent to the Pacific Bell service or customer category for which it was incurred, Pacific Bell allocated these costs based on the regulated and non-regulated time assignments of a very small number of Pacific Bell administrative employees. As a result, these costs were not allocated between regulated and non-regulated activities in accordance with attributable cost principles as set out in	Concur with Overland	

R.01-09-001 / I.01-09-002

**Joint Schedule of Overland Consulting, Inc.'s, ORA's, and TURN's
Position on Adjustments (as requested by ALJ Sarah Thomas)
9/20/2002**

Index #	Rate Base or Income Stmt	Adjust Ref.	Report Chapter	Testimony Reference	Adjustment Description	Overland Position	ORA Position	TURN Position
						FCC Part 64 (adopted by the CPUC in D.91-07-056).		
62	IS	NR-03	20 - 31	GO Reply 10	Customer Service Non-Productive Salary Allocations (IS) - Corrects the allocation of service labor to non-regulated activities.	Non-productive customer service labor was not allocated to non-regulated activities in the same proportion as productive labor costs.	Concur with Overland	
63	IS	NR-04	20 - 37	RW Reply 14; GO Reply 9	Affiliate Marketing Services Revenue (IS) - Increases affiliate marketing services revenue to the same level as the associated expenses.	Pacific Bell employed two different systems to account for the revenues and expenses associated with the sales functions performed by Pacific Bell customer service representatives on behalf of its affiliates. Although the revenues should have been at least equal to the expenses for these services, expenses were significantly greater than revenues. Pacific Bell could not provide a credible explanation for this discrepancy.	Concur with Overland. Additionally, adjustment should recognize 10% markup of FDC pursuant to CPUC affiliate rules.	

R.01-09-001 / I.01-09-002

**Joint Schedule of Overland Consulting, Inc.'s, ORA's, and TURN's
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9/20/2002**

Index #	Rate Base or Income Stmt	Adjust Ref.	Report Chapter	Testimony Reference	Adjustment Description	Overland Position	ORA Position	TURN Position
64	IS	NR-05	20 - 48		Non-regulated Tracking Code Direct Assignment Errors (IS) - Corrects the allocation of costs between regulated and non-regulated activities.	Tracking codes were a primary tool used by Pacific Bell in allocating costs between regulated and non-regulated activities. During our review, we noted several instances in which tracking codes identified as non-regulated in nature were actually allocated on a different basis. By disregarding the true nature of the costs when allocating between regulated and non-regulated activities, Pacific Bell was in non-compliance with D.91-07-056 (Finding of Fact 11).	Concur with Overland	
65	IS	NR-06	20 - 48	GO Reply 9	National-Local Strategy Implementation (IS) - Corrects the allocation of costs associated with offering competitive local exchange services.	D.91-07-056 (Finding of Fact 11) establishes a cost-attribution hierarchy beginning with direct assignment of costs when possible. Pacific Bell chose to jointly allocate the implementation costs of offering competitive local exchange service outside of the Pacific Bell franchise territory between regulated and non-regulated activities. However, a Pacific Bell affiliate is responsible for this initiative and should have been allocated all of these costs.	Concur with Overland	

R.01-09-001 / I.01-09-002
Joint Schedule of Overland Consulting, Inc.'s, ORA's, and TURN's
Position on Adjustments (as requested by ALJ Sarah Thomas)
9/20/2002

Index #	Rate Base or Income Stmt	Adjust Ref.	Report Chapter	Testimony Reference	Adjustment Description	Overland Position	ORA Position	TURN Position
66	IS	NR-07	20 - 25		1997 Corporate Sponsorship Costs (IS) - Corrects the below-the-line treatment of corporate advertising and sponsorship payments associated with the naming rights of Pacific Bell Park.	Corporate advertising and sponsorship payments associated with the naming rights of Pacific Bell Park were charged to regulated activities. CPUC policy established in Decision 86-01-026 (p. 41) prohibits regulated expense recovery of these expenses.	Concur with Overland	
67	IS	NR-08	20 - 50		Customer Premise Equipment Costs (IS) - Corrects the allocation of certain costs associated with customer premise equipment.	Certain costs associated with customer premise equipment was not appropriately identified by tracking code. As a result, these costs incorrectly defaulted to regulated operating expense rather than non-regulated expense as intended by the FCC and CPUC.	Concur with Overland	
68	IS	REG-41; Supp 5	S5 - 1	GH Open 2	PIU Accrual (IS) - Reduce 1997 revenues to eliminate settlement amount that should have been accrued in 1996.	Pacific Bell had sufficient information to accrue the settlements in 1996.	Concur with Overland	
69	IS	REG-42; Supp 5	S5 - 2	GH Open 2	USOAR Turnaround Accrual (IS) - Reduce 1997 revenues to correct over-accrual of regulatory liability in 1996. The reversal of the recorded liability in 1997 overstated 1997 revenues.	The entries recorded in 1997 to reverse the prior-period over-accrual distort 1997 operating revenues. The correction reduces 1997 revenues to eliminate that distortion.	Concur with Overland	

R.01-09-001 / I.01-09-002

**Joint Schedule of Overland Consulting, Inc.'s, ORA's, and TURN's
Position on Adjustments (as requested by ALJ Sarah Thomas)
9/20/2002**

Index #	Rate Base or Income Stmt	Adjust Ref.	Report Chapter	Testimony Reference	Adjustment Description	Overland Position	ORA Position	TURN Position
70b	IS	REG-43; Supp 6	S6 - 1	GH Open 2	LNP Depreciation (IS) - Reduce depreciation expense to correct a separations error.	The depreciation expense for the plant costs recovered through the FCC LNP tariff should be directly assigned to the interstate jurisdiction.	Concur with Overland	The costs incurred prior to May 1998 should have been deferred as a regulatory asset pursuant to FAS 71 requirements. Pacific Bell had sufficient information to estimate the probable amount of cost recovery in early 1996.
71b	IS	REG-44; Supp 10	10 - 17, S10 - 1		AFUDC Depreciation Expense (IS) - Reduce depreciation expense to reflect corrected plant balances. The AFUDC recorded by Pacific Bell during the audit period was overstated.	The CPUC basis AFUDC charged to plant during the audit period was excessive. Pacific Bell's AFUDC rate calculations violated Resolution RF-4. Pacific Bell's practice of imputing negative capital sources in its AFUDC rate calculations does not have any basis in regulatory, finance or accounting theory. This correction is directly related to the AFUDC rate base correction.	Concur with Overland	

R.01-09-001 / I.01-09-002

**Joint Schedule of Overland Consulting, Inc.'s, ORA's, and TURN's
Position on Adjustments (as requested by ALJ Sarah Thomas)
9/20/2002**

Index #	Rate Base or Income Stmt	Adjust Ref.	Report Chapter	Testimony Reference	Adjustment Description	Overland Position	ORA Position	TURN Position
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Rate Base Adjustments

27	RB	REG-29	11 - 5, S11 - 5	GH Reply 13	Cash Working Capital (RB) - Reduce cash working capital allowance to correct errors and to reflect audit adjusted expenses.	Adjusts cash working capital allowance to correct 20 errors made in Pacific Bell's lead-lag studies and to reflect audit adjusted expenses.	Concur with most of Overland's adjustments. Also note that Pacific Bell included non-cash items, such as depreciation expense, in CWC calculation, which results in overstatement of rate base. The CWC would be negative if the non-cash items were removed. ORA recommends that CWC instead be set equal to zero. The result is similar to the three-year average rate base effect presented by Overland, and greatly simplifies the IEMR process.	The cash working capital allowance should be set equal to zero for IEMR purposes, the most reasonable option given the considerable doubt as to the accuracy or reasonableness of the utility's cash working capital calculations.
28	RB	REG-30	11 - 28	GH Open 12	Prepaid Directory Expense (RB) - Include prepaid directory expense in rate base.	Rate base should reflect Pacific Bell's actual investment in providing service. Prepaid directory expense represents an investment in providing service that should be included in rate base. D.91-07-056 does not prohibit the correction.	Concur with Overland	

29	RB	REG-31	11 - 30	GH Open 12, GH Reply 19	SFAS 112 Liability (RB) - Deduct SFAS 112 liability from rate base.	The accrued SFAS 112 liability represents non-investor supplied capital that should be deducted from rate base. D.91-07-056 does not prohibit the correction.	Concur with Overland	
30	RB	REG-32	11 - 31	GH Open 12, GH Reply 19	Vacation Liability (RB) - Deduct accrued vacation liability from rate base.	The accrued vacation liability represents non-investor supplied capital that should be deducted from rate base. D.91-07-056 does not prohibit the correction.	Concur with Overland	
31	RB	REG-33	11 - 31	GH Open 12	SFAS 106 Accrued Liability (RB) - Deduct accrued SFAS 106 liability from rate base. Amount depends on resolution of SFAS 106 expense correction.	The accrued SFAS 106 liability represents non-investor supplied capital that should be deducted from rate base. D.91-07-056 does not prohibit the correction.	Concur with Overland	
32	RB	REG-34	11 - 34	GH Open 12	Accrued Contingent Liability (RB) - Deduct accrued contingent liabilities from rate base. Amount depends on resolution of expense correction for unauditable contingent liabilities.	Accrued contingent liabilities represent non-investor supplied capital that should be deducted from rate base. D.91-07-056 does not prohibit the correction.	Concur with Overland	
33	RB	REG-35	11 - 28, S11 - 6	GH Open 12, GH Reply 19	Prepaid Pension Costs (RB) - Include prepaid pension asset in rate base. Amount depends on resolution of Phase 2A pension expense correction.	Prepaid pension assets represent an investment in providing service that should be included in rate base. D.91-07-056 does not prohibit the correction.	Concur with Overland	

34	RB	REG-36	10 - 22	GH Open 3	SFAS 106 Plant (RB) - Reduce 1998 and 1999 plant to reflect CPUC PBOP accounting policy.	Directly related to Phase 2A PBOP expense correction. Pacific Bell wrote-off PBOP regulatory asset in 1998. That write-off included the elimination of a large rate base credit. The Phase 2A PBOP correction reverses the expense impact of the write-off. This correction eliminates the rate base impact of the write-off. The rate base correction should be adopted if the Phase 2A PBOP expense correction is adopted.	Concur with Overland	
35	RB	REG-37	10 - 22, S10 - 3		Restructure Reserve (RB) - Reduce net plant to eliminate unsupported and unreasonable jurisdictional adjustment.	Pacific Bell's recorded plant balances include a jurisdictional adjustment for the impact of a 1993 restructuring reserve. The FCC and CPUC accounting treatment of the restructuring reserve was identical. Therefore, there is no basis for the recorded jurisdictional adjustment. Pacific Bell admits it cannot support the jurisdictional adjustment recorded on its books or explain what the adjustment represents..	Concur with Overland	
36	RB	REG-38	10 - 23		Accumulated Reserve for Depreciation (RB) - Adjust depreciation reserve to reflect depreciation expense corrections.	Directly related to depreciation expense corrections. This correction adjusts rate base to reflect impact of depreciation expense corrections on accumulated reserve for depreciation.	Concur with Overland	

37	RB	REG-39	9 - 23		Accumulated Deferred Income Tax (RB) - Adjust accumulated deferred income taxes to reflect the CPUC's flow-through income tax accounting policy.	The rate base correction should reflect the resolution of the income tax normalization issue in Phase 2A.	Concur with Overland	
38	RB	REG-40	9 - 21		Excess Deferred Income Tax (RB) - Adjust Accumulated deferred income taxes to correct accounting error.	This correction is directly related to the income statement correction for excess deferred income tax amortization. The rate base correction should be made if the income statement correction is adopted.	Concur with Overland	
ORA	RB				Remove ADSL Development Costs		See corresponding description of income statement adjustment above.	Pacific Bell should not be allowed to recover development costs through NRF rates, then transfer the ADSL service so that future revenues from that service are not reflected in the IEMR. Instead, the ADSL development costs should be removed from the IEMR during the audit period.
60a	RB	NR-01	20 - 20	GO Reply 10	Depreciation Expense Timing Adjustment (RB) - The allocation between regulated and non-regulated activities was not correct on a year-to-date basis. This entry corrects this error.	Contrary to the cost attribution hierarchy adopted by the CPUC in D.91-07-056 (Finding of Fact 11), when correcting a depreciation expense error in December 1999, Pacific Bell employed current regulated / non-regulated allocation ratios which were not reflective of the actual ratios in use at the time when the errors were originally recorded.	Concur with Overland	

70a	RB	REG-43; Supp 6	S6 - 1	GH Open 2	LNP Capital Costs (RB) - Reduce net plant to correct a separations error.	The plant costs recovered through the FCC LNP tariff should be directly assigned to the interstate jurisdiction.	Concur with Overland	The costs incurred prior to May 1998 should have been deferred as a regulatory asset pursuant to FAS 71 requirements. Pacific Bell had sufficient information to estimate the probable amount of cost recovery in early 1996.
71a	RB	REG-44; Supp 10	10 - 17, S10 - 1	GH Open 3	AFUDC (RB) - Reduce net plant to correct an accounting error. The AFUDC rates used by Pacific Bell were overstated.	The CPUC basis AFUDC charged to plant during the audit period was excessive. Pacific Bell's AFUDC rate calculations violated Resolution RF-4. Pacific Bell's practice of imputing negative capital sources in its AFUDC rate calculations does not have any basis in regulatory, finance or accounting theory. This correction is directly related to the AFUDC depreciation correction.	Concur with Overland	
72	RB	REG-45; Supp 10	S10 - 2	GH Open 3	PBOP Pre-Funding Plant Adj. (RB) - Reduce net plant to eliminate unsupported and unreasonable jurisdictional adjustment.	Pacific Bell's recorded plant balances include a jurisdictional adjustment for the capitalized portion of contributions it made to its PBOP trusts in 1989 and 1990, prior to the adoption of FAS 106. The proper FCC and CPUC basis accounting for the contributions was identical. Therefore, there is no basis for the jurisdictional adjustment and it should be eliminated. Pacific Bell properly charged the contributions to expense for FCC purposes. Pacific Bell improperly accounted	Concur with Overland	

						for contributions as prepaid PBOP assets for CPUC purposes. Pacific Bell's CPUC basis accounting violated CPUC accounting policy and was inconsistent with its accounting for similar contributions made to other PBOP trusts.		
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APPENDIX D

APPENDIX D

UNDISPUTED AUDIT ADJUSTMENTS			
Issue	Amount of Adjustment²⁵⁴		
	1997	1998	1999
Revenues and Other Operating Income Adjustments			
Bellcore Dividends Index #2 ²⁵⁵	\$3,883,507		
Gain on Sale of Bellcore Index #4	9,122,587		
Operating Expenses			
ACN Shutdown Costs Index #8	17,846,219	4,284,040	2,226,486
ISP-Bound Traffic Separations Index #12	(11,329,359)		
Depreciation Accounting			
Equal Access IEMR Ratemaking Adjustment Index #20		(6,477,055)	

²⁵⁴ Positive numbers represent additions to income (in the case of “Revenues and Other Operating Income”) or to expense (in the case of “Operating Expenses,” “Depreciation Accounting,” “Affiliate Transactions,” and “Regulated and Nonregulated Cost Allocations”), and negative numbers (in parentheses) indicate decreases in income or expense.

²⁵⁵ Index numbers cross-reference to the chart entitled “Joint Exhibit of Overland Consulting, Inc., ORA, TURN and Pacific Bell Showing Impact of Audit Corrections on Pacific Bell’s Reported IEMR Results for 1997-1999,” Appendix A hereto.

Affiliate Transactions²⁵⁶			
SBC Operations Merger Conforming Expense Index #39			1,656,603
SBC Operations Secondary Allocation of Parent Management Fees Index #42		291,835	270,743
SBC Operations Call Center Depreciation and Merger Implementation Expense Index #43		237,025	
SBC Services, CFL and TRI Allocation of Parent Management Fees Index #45		265,789	216,392
Parent Political and Legislative Influence Expense Index #47	8,574,885	10,009,837	4,186,554
Parent Contributions, Memberships and Foundation Expense Index #52	161,013	657,620	3,067,831

²⁵⁶ Undisputed affiliate transactions issues also appear in Pacific's Exh. 2B:362A.

Parent SFAS 106 Merger Conforming Expense Index #54			454,553
Parent Impact on Pacific Bell Directory – Contributions and Memberships Index #55a	75,500	259,236	195,782
Parent Impact on Pacific Bell Directory – Lobbying Expense Index #55e	389,744	729,081	881,323
Parent Impact on Pacific Bell Directory – Parent Management Fees Index #55j		1,145,479	1,248,344
Parent Impact on Pacific Bell Directory – Employee Transfer Fees Index #55k	58,754		
Parent Employee Transfer Fees Billed Back to Pacific Index #57	626,616		
Nevada Bell Net Directory Revenue Index #59			(11,253,000)
Regulated and Nonregulated Cost Allocations			
Nonregulated Tracking Code Assignment Error Index #64	7,398	4,250,163	3,237,874

Customer Premises Equipment Costs Index #67		10,097,537	3,467,830
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CERTIFICATE OF SERVICE

I certify that I have this day served a true copy of the original attached Notice of Availability of Draft Decisions and Alternate Draft Decisions Regarding Phase 2A and Phase 2B Audit Issues on all parties of record in this proceeding or their attorneys of record.

Dated August 29, 2003, at San Francisco, California.

/s/ KRIS KELLER

Kris Keller